Agenda ref **10E**

STAFF PAPER

17 January – 18 January 2012

IFRS Interpretations Committee Meeting

[this box can be used to give additional meeting dates]

Project	**2009-2011 Annual improvements cycle (ED June 2011)—Comment letter analysis**		
Paper topic	IAS 32 *Financial Instruments: Presentation*—Tax effect of distribution to holders of equity instruments		
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Introduction

1. The exposure draft of proposed *Improvements to IFRSs* published in June 2011 included a proposed amendment to IAS 32 *Financial Instruments: Presentation* to clarify that income tax relating to distributions to holders of an equity instrument and income tax relating to transaction costs of an equity transaction should be accounted for in accordance with IAS 12 *Income Taxes*.

Objective of this paper

2. The objective of this paper is to provide an analysis of the comment letters received on the proposal to amend IAS 32 and to obtain a final decision from the IFRS Interpretation Committee (the 'Committee') to allow this issue to be included in the final *Improvements to IFRSs* planned to be issued in 2012.

Structure of this paper

3. This agenda paper:

   (a) provides background information on the issue;

   (b) analyses the comments received as part of the exposure draft process and recommends changes to the proposed draft wording; and

   (c) requests the IFRS Interpretation Committee (the Committee) to confirm whether they agree with the staff's recommendations to proceed with the proposed amendment by adding some further changes in the Basis for Conclusions that would make the proposed amendment clearer.

Background

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. The conflict exists because both IAS 32 and IAS 12 provide guidance on income tax on equity transactions, but the guidance that they give is different.

5. At the Committee meeting in March 2010[1], the Committee recommended that the Board should amend IAS 32 to clarify that the income tax effect of both distributions to equity holders and transaction costs relating to equity transactions should be accounted for in accordance with IAS 12. The Committee decided to recommend that the Board should add this issue to the 2009─2011 annual improvements (AIP) cycle, because this is a clarification rather than a change of the principles in IAS 12.

[1] http://www.ifrs.org/NR/rdonlyres/0E6AF6F8-9A54-4357-BE23-04BC1B85CA2D/0/1003ap6CobsIFRICIAS12TaxEffectofDistributionstoEquityHolders.pdf

6. At the Board meeting in July 2010[2], the Board agreed with the Committee. Consequently, the Board proposed to amend IAS 32 to clarify that the income tax consequences of distributions to holders of equity instruments should be accounted for in accordance with IAS 12. In addition, the Board decided to include the proposed amendment within the exposure draft *Improvements to IFRSs* published in June 2011.

7. In this paper, we discuss and analyse the comments received from constituents during the comment period which ended on the 21 October 2011.

Comment letter analysis

8. The Board received 67 comment letters on the exposure draft (ED). The ED asked two questions:

    (a) Question 1: Do you agree with the Board's proposal to amend the IFRS as described in the exposure draft? If not, why and what alternative do you propose?) [53 respondents answered this question]

    (b) Question 2: Do you agree with the proposed transitional provisions and effective date for the issue as described in the exposure draft? [51 respondents answered this question]

Proposed amendment to IAS 32

9. Respondents broadly agree with the proposed amendment to IAS 32 to clarify that income tax relating to distributions to holders of an equity instrument and income tax relating to transaction costs of an equity transaction should be accounted for in accordance with IAS 12.

[2] http://www.ifrs.org/Meetings/IASB+Board+Meeting+21+July+2010.htm Agenda Paper 14C.

Potential inconsistencies in IAS 12 on income tax on dividends

Paragraphs 52B and 58 and 61A

10. Many respondents[3] perceive an inconsistency between the guidance in IAS 12 on the income tax consequences on dividends in paragraph 52B and the guidance in paragraphs 58 and 61A because they observe that:

    (a) income tax consequences of dividends are recognised <u>in profit or loss</u> in accordance with <u>paragraph 52B</u>; however,

    (b) because dividends are viewed as an equity transaction with shareholders, one might conclude that the income tax consequences of dividends should be recognised <u>outside profit or loss</u> (ie other comprehensive income or equity), because in accordance with paragraphs <u>58 and 61A</u>, the income tax that arises from transactions that are recognised in other comprehensive income or equity should be recognised outside profit or loss (ie other comprehensive income or equity).

11. Paragraphs 52A and 52B state that (emphasis added) (paragraph 52A is provided for ease of reference):

> 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

[3] See Comment Letter (CL) 8 (SFRB), CL 13 (AFME), CL 14(ICAC), CL 17 (Roche Group), CL 25 (FAR), CL 28 (PWC), CL 36 (GASB), CL 42 (ICAI), CL 55 (ANC), CL 61(SEBI), CL 64 (ICAEW) and CL 67 (EFRAG).

> 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)**.

12. Paragraph 58 and 61A state that (emphasis added):

> 58 **Current and deferred tax shall be recognised** as income or an expense and included i**n profit or loss for the period**, **<u>except to</u> 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).
>
> 61A **Current tax and deferred tax shall be recognised outside profit or loss if the tax relates to items that are recognised, in the same or a different period, outside profit or loss**. Therefore, current tax and deferred tax that relates to items that are recognised, in the same or a different period:
>
> (a) in other comprehensive income, shall be recognised in other comprehensive income (see paragraph 62).

> (b) directly in equity, shall be recognised directly in equity (see paragraph 62A).

13. Respondents believe that the Board should also deal with this issue (ie the perceived inconsistency in IAS 12 on the income tax consequences on dividends) as part of the proposed annual improvement, because they think that amending IAS 32 without addressing the apparent inconsistency between paragraph 52B (ie income tax related to dividends is recognised in profit or loss) and paragraphs 58 and 61A (ie income tax related to dividends is recognised in equity) may not clarify the accounting for income tax on dividends.

14. To address this perceived inconsistency in IAS 12, respondents suggest a further amendment to IAS 12 to clarify the interaction between paragraphs 52B and 58(a).

Diversity in the application of paragraph 65A

15. One respondent (CL 28 PWC) points out that there is also diversity in the application of paragraph 65A of IAS 12. This paragraph provides guidance when dividends are subject to withholding tax. Paragraph 65A in IAS 12 states that (emphasis added):

> 65A **When an entity pays dividends to its shareholders, it may be required to pay a portion of the dividends** to taxation authorities on behalf of shareholders. In many jurisdictions, this amount is referred to as a **withholding tax**. Such an amount paid or payable to taxation authorities **is charged to equity as a part of the dividends**.

16. We provide below some extracts of the respondent's letter where it states the reasons why the tax consequences of a dividend are not clear (emphasis added):

> **CL 28 PWC** (Extract)
>
> It is often not clear whether the tax consequences of a dividend are in substance additional income tax that should be accounted for in accordance with paragraphs 52A and 52B or in substance payments on behalf of shareholders.

> For example, **a dividend distribution tax may be paid by the reporting entity at the time of a distribution, but some recipients do not obtain a tax credit for the amount paid to the tax authority. This may indicate a tax on the distribution of retained earnings**. **Other recipients receive a tax credit for the dividend distribution tax and some dividends are exempt from the tax because the recipients are tax exempt, which may suggest a tax paid on behalf of shareholders.**
>
> We are aware that some entities have used the inconsistency between IAS 12 and IAS 32 as a basis to conclude that specific tax consequences, such as those described above should be recognised in equity. **The existing diversity in practice could be addressed by amending paragraph 65A to provide some indicators, such as those in ASC 740-10-15-4,** of when a tax on distributions is paid on behalf of shareholders and when it is additional income tax on the entity's retained earnings.

17. This respondent thinks that paragraph 65A could be amended to provide some indicators on when a tax on distributions is paid on behalf of shareholders and when it is additional income tax on the retained earnings.

Staff analysis

18. We note that in **Agenda Paper 14C** of July 2010 the staff addressed the apparent inconsistency between paragraph 52B and paragraphs 58 and 61A (see paragraphs 17–20 of that Agenda Paper) and concluded that this guidance is consistent.

19. We agree that the guidance within IAS 12 on accounting for the income tax effects of dividends is consistent, because the principle in paragraph 58 of IAS 12 is that current and deferred tax shall be recognised in profit and loss <u>subject to</u> the two exceptions included in paragraph 58(a) and (b).

20. The exception included in paragraph 58(a) applies to transactions that are recognised outside of profit and loss, such as those recognised directly in equity. We understand respondents' concerns that the guidance in this paragraph could be interpreted that because dividend transactions are distributions to owners, the tax on dividends should be recognised in equity in accordance with paragraph 58(a).

21. However, paragraph 52B of IAS 12 provides <u>specific guidance</u> on the accounting for the income tax consequences of dividends. <u>This guidance requires an entity to link the income tax consequences of dividends to past transactions or events rather than to distributions to owners.</u>

22. To the extent that the dividend is linked to past transactions that were originally recognised in profit and loss, the income tax consequences of the dividend should be recognised in profit and loss. This accounting is consistent with the view in paragraph 57 of IAS 12, which states that the 'accounting for the current and deferred tax effects of a transaction or other event is consistent with the accounting for the transaction or event itself'. Conversely, when the dividend is linked to past transactions originally recognised in other comprehensive income or equity, the entity should apply the exception in paragraph 58(a) of IAS 12, and recognise the income tax consequences of dividends outside of profit and loss, in accordance with paragraph 61A of IAS 12.

23. Finally, we think that the issue raised regarding the guidance in paragraph 65A of IAS 12 where dividends are paid by an entity subject to withholding tax, is not part of the proposed amendment described in this paper. We think that the issue raised by the respondent in this respect is a broader question that should be dealt within a future review of IAS 12 rather than as a limited annual improvement to IAS 12, because the issue raises the question of whether the accounting for tax should differ depending on each shareholder's tax status.

Staff recommendation

24. On the basis of the analysis in the previous section, we think that the guidance in paragraph 52B and paragraphs 58 and 61A is consistent and we do not think that

any further clarification is needed in IAS 12. Consequently, we think that the Committee should recommend to the Board that it should proceed with the proposed amendment in IAS 32.

25. However, to address the main concern raised by respondents, we think that the proposed Basis for Conclusions accompanying IAS 32 could further clarify the content of the guidance in IAS 12 in paragraphs 52A and 52B and 58 to state in which cases each guidance should be applied.

26. Our recommended changes are included as appendices:

(a) **Appendix A** shows the proposed amendment, including our recommendations in this paper, highlighting differences from the currently effective standard; and

(b) **Appendix B** shows revisions to the wording in the previously published exposure draft, following our recommendations in this paper.

Questions to the Interpretations Committee

Questions
1. Does the Committee agree to recommend to the Board that it should proceed with the amendment? 2. Does the Committee agree with the proposed amendment to the Basis for Conclusions of IAS 32 to further clarify the guidance in paragraphs 52A and 52B and 58 of IAS 12 (refer to Appendix A of this paper)? If not, what does the Committee recommend, and why?

Appendix A—Draft wording of the proposed amendment, showing differences from the currently effective standard

Proposed amendments to IAS 32 *Financial Instruments: Presentation*

Paragraphs 35, 37 and 39 are amended (new text is underlined and deleted text is struck through). Paragraphs 35A and 97L are added.

Presentation

Interest, dividends, losses and gains (see also paragraph AG37)

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 <u>recognised</u> ~~debited~~ by the entity directly ~~to~~ <u>in</u> 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~~.**

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

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 otherwise would 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~~ <u>in accordance with</u> 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*.~~

Effective date and transition

97L *Improvements to IFRSs* issued in [date] amended paragraphs 35, 37 and 39 and added paragraph 35A. An entity shall apply those amendments for annual periods beginning on or after 1 January 2013. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact.

Basis for Conclusions on IAS 32 Financial Instruments: Presentation

This Basis for Conclusions accompanies, but is not part of, the proposed amendments.

Paragraphs BC33A-BC33C are added.

Income tax consequences of distributions to holders of an equity instrument and of transaction costs of an equity transaction

BC33A The Board was asked to address a perceived inconsistency between IAS 12 *Income Taxes* and IAS 32 *Financial Instruments: Presentation* regarding the recognition of income tax relating both to distributions to holders of an equity instrument and to transaction costs of an equity transaction. Paragraph 52B of IAS 12 requires the recognition of the income tax consequences of dividends in profit or loss except when the circumstances described in paragraph 58(a) and (b) of IAS 12 arise. However, paragraph 35 of IAS 32 requires the recognition of income tax relating to distributions to holders of an equity instrument in equity.

BC33B The Board noted that the intention of IAS 32 was to follow the requirements in IAS 12 for accounting for income tax relating to distributions to holders of an equity instrument and income tax relating to transaction costs of an equity transaction. Consequently, the Board proposes to add paragraph 35A to IAS 32 to clarify this intention.

BC33C The amendment clarifies that the income tax consequences of dividends are recognised in profit or loss in accordance with paragraph 52B of IAS 12. Consequently, to the extent that the dividend relates to income arising from a transaction that was originally recognised in profit or loss, the income tax on the dividend should be recognised in profit or loss. Whereas if the dividend relates to income or a contribution arising from a transaction that was originally recognised in other comprehensive income or equity, respectively, the entity should apply the exception in paragraph 58(a) of IAS 12, and recognise the income tax consequences of the dividend outside of profit or loss. The amendment also clarifies that the tax effect of distributions to holders of an equity instrument other than dividends and the tax effect of transaction costs of an equity transaction are recognised in accordance with the principle in paragraph 57 of IAS 12.

Appendix to proposed amendments to IAS 32 – Consequential amendment to IFRIC 2

Members' Shares in Co-operative Entities and Similar Instruments

In the rubric 'paragraphs 1-14A is amended to 'paragraphs 1-17'. Paragraph 11 is amended (deleted text is struck through). Paragraph 17 is added.

Consensus

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.

Effective date

17 *Improvements to IFRSs* issued in [date] amended paragraph 11. An entity shall apply that amendment retrospectively for annual periods beginning on or after 1 July 2013. If an entity applies the amendment to IAS 32 as a part of the *Improvements to IFRSs* issued in [date] for an earlier period, the amendment in paragraph 11 shall be applied for that earlier period.

Appendix B—Draft wording showing changes from the exposure draft published in June 2011 following our recommendations in this paper

Proposed amendments to IAS 32 *Financial Instruments: Presentation*

Paragraphs 35, 37 and 39 are amended (for ease of reference new text is underlined and deleted text is struck through). Paragraphs 35A and 97L are added.

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Interest, dividends, losses and gains (see also paragraph AG37)

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 recognised by the entity directly in equity. Transaction costs of an equity transaction shall be accounted for as a deduction from equity.**

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

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 to the extent that they are incremental costs directly attributable to the equity transaction that otherwise would 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 in accordance with IAS 1.

Effective date and transition

97L *Improvements to IFRSs* issued in [date] amended paragraphs 35, 37 and 39 and added paragraph 35A. An entity shall apply those amendments ~~retrospectively~~ for annual periods beginning on or after 1 January 2013. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact.

Basis for Conclusions on IAS 32 *Financial Instruments: Presentation*

This Basis for Conclusions accompanies, but is not part of, the proposed amendments.

Paragraphs BC33A-BC33C are added.

Income tax consequences of distributions to holders of an equity instrument and of transaction costs of an equity transaction

BC~~1~~33A The Board was asked to address a perceived inconsistency between IAS 12 *Income Taxes* and IAS 32 *Financial Instruments: Presentation* regarding the recognition of income tax relating both to distributions to holders of an equity instrument and to transaction costs of an equity transaction. Paragraph 52B of IAS 12 requires the recognition of the income tax consequences of dividends in profit or loss except when the circumstances described in paragraph 58(a) and (b) of IAS 12 arise. However, paragraph 35 of IAS 32 requires the recognition of income tax relating to distributions to holders of an equity instrument in equity.

BC~~2~~33B The Board noted that the intention of IAS 32 was to follow the requirements in IAS 12 for accounting for income tax relating to distributions to holders of an equity instrument and income tax relating to transaction costs of an equity transaction. Consequently, the Board proposes to add paragraph 35A to IAS 32 to clarify this intention.

BC~~3~~33C The amendment clarifies that the income tax consequences of dividends are recognised in profit or loss in accordance with paragraph 52B of IAS 12. Consequently, to the extent that the dividend relates to income arising from a transaction that was originally recognised in profit or loss, the income tax on the dividend should be recognised in profit or loss. Whereas if the dividend relates to income or a contribution arising from a transaction that was originally recognised in other comprehensive income or equity, respectively, the entity should apply the exception in paragraph 58(a) of IAS 12, and recognise the income tax consequences of the dividend outside of profit or loss. ~~except to the extent that the income tax consequences of dividends arise from the circumstances described in paragraph 58(a) and (b) of IAS 12. It~~ The amendment also clarifies that the tax effect of distributions to holders of an equity instrument other than dividends and the tax effect of transaction costs of an equity transaction are recognised in accordance with the principle in paragraph 57 of IAS 12.

Appendix to proposed amendments to IAS 32 – Consequential amendment to IFRIC 2

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Consensus

11 As required by paragraph 35 of IAS 32, distributions to holders of equity instruments are recognised directly in equity. 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.

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