

STAFF PAPER

13 March–14 March 2012

IFRS Interpretations Committee Meeting

Project	IAS 1 <i>Presentation of Financial Statements</i> and IAS 12 <i>Income Taxes</i>		
Paper topic	Presentation of payments of non-income taxes		
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination. Decisions made by the IFRS Interpretations Committee are reported in *IFRIC Update*. The approval of a final Interpretation by the Board is reported in *IASB Update*.

Objective and introduction

1. The IFRS Interpretations Committee (the Committee) received a request to clarify the presentation in the statement of comprehensive income of royalty payments claimed as an allowance against income tax. The objective of this Agenda Paper is to provide the Committee with an update on the staff's research and analysis to date on this issue. In addition, the staff are seeking to obtain preliminary views and guidance from the Committee to assist them.
2. This Agenda Paper includes:
 - (a) background information on the issue;
 - (b) staff analysis to date;
 - (c) outreach activities to date;
 - (d) agenda criteria and staff recommendation on the next steps; and
 - (e) questions for the Committee.

Background

3. In December 2011, the Committee received a request seeking clarification on whether the production-based royalties paid to one taxation authority that are claimed as an allowance against income tax payables to another taxation authority

under a proposed tax regime should be presented as operating expense or as a tax expense. In addition, in February 2012, we received another submission from a different submitter on this issue. Even though the excerpts from the submission are included in this agenda paper as Appendix A2, the discussions presented in the submission are not contemplated in our analysis due to time constraints. The tax legislation is proposed to be effective from 1 July 2012 in the jurisdiction.

4. In June 2011, the Australian Government released a draft Exposure Draft of proposed Minerals Resource Rent tax (MRRT) legislation. The proposed MRRT would apply to the mining of iron ore and coal in Australia.
5. According to the submission, under the proposed tax regime, payments to a local taxation authority for production-based royalties will become deductible in calculating MRRT payable to the government. The royalties are grossed up by the tax rate levied by the government when calculating taxable profit for MRRT, which results in a 100 per cent credit against the tax payables to the government. Assuming that the tax rate is 25 per cent and that the amount of royalty payments is CU 25¹, the entity can deduct CU 100 (= CU 25 / 0.25) when arriving at taxable profit on which MRRT payable to the government under the new tax regime is based.
6. As the basis for this submission, the submitter assumes that the royalty payments are, in themselves, **outside the scope of IAS 12 *Income taxes*** while MRRT is within the scope of IAS 12.
7. The submitter states that there are two views for the presentation of the royalty payments in the statement of comprehensive income:
 - (a) View 1: Presented as **operating expenses or production cost**
 - (b) View 2: Presented as **tax expense**.

View 1: Operating expenses or production cost

8. Supporters of View 1 argue that payments for the royalties made to one taxation authority should not be presented in income taxes, because the royalty payments do not, in themselves, meet the definition of income taxes under IAS 12.

View 2: Tax expense

¹ In this Agenda Paper, monetary amounts are denominated in “currency units (CU)”.

9. As highlighted above, under the proposed MRRT legislation, the amounts of the royalty payments to one taxation authority are claimed as an allowance against income tax payables to another taxation authority. Therefore, supporters of this view argue that the nature of the payments in the form of non-income taxes could be considered payments that are, in substance, **prepayment of income taxes** within the scope of IAS 12.
10. Proponents of View 2 also note the use of plural term ‘taxation authorities’ in the definition of taxable profit under IAS 12. IAS 12 defines taxable profit (tax loss) as follows (emphasis added):

5. [...] Taxable profit (tax loss) is the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable). [...]
11. They think that the plural term used in the definition of taxable profit indicates that the distinction between which taxation authority the taxes are payable to is not relevant when determining the scope of income taxes under IAS 12. They believe that this further supports their argument that the royalty payments to a local government could fall within the scope of IAS 12 and could be accounted for as part of MRRT.
12. For ease of reference, the text of the submissions is reproduced in Appendix A to this paper.

Staff analysis to date

13. With regard to this issue, we first performed an analysis on whether IFRSs require an entity to include specific expenses in the line item of ‘tax expense’ in an entity’s statement of comprehensive income. Secondly, we considered the interpretation of the use of plural terms ‘taxation authorities’ in the definition of taxable profit in IAS 12. After that, we analysed whether non-income tax payments that are deductible against income taxes could be accounted for as prepayment of income taxes within the scope of IAS 12.

Scope of tax expense in IAS 1

14. Paragraph 82 of IAS 1 *Presentation of Financial Statements* lists line items that an entity is required to present in the statement of comprehensive income, including ‘tax expense’:

82. In addition to items required by other IFRSs, the profit or loss section or the statement of profit or loss shall include line items that present the following amounts for the period:

[...] (d) tax expense; [...]

15. Because current IAS 1 does not have clear background for the requirement in paragraph 82(d) above, we analysed the discussions of the Board of the International Accounting Standards Committee (IASC), which led the line item of ‘tax expense’ to first appear in IAS 1 as a required line item.
16. The line item of ‘tax expense’ was first itemised as a minimum requirement in IAS 1 *Presentation of Financial Statements (revised 1997)*, which was approved by the Board of the IASC in July 1997. In relation to the addition of the line item of ‘tax expense’, Exposure Draft E53, *Presentation of Financial Statements*, which was published in July 1996, states as follows (emphasis added):

92. Other International Accounting Standards require items to be presented on the face of the income statement. For example, IAS 8 requires profit or loss from ordinary activities and extraordinary items to be presented on the face of the income statement. IAS 12 requires the tax expense on profit or loss from ordinary activities to be presented on the face of the income statement.

17. Even though ‘tax expense’ was not originally listed as an line item in the exposure draft, paragraph 92 of the exposure draft indicates that the Board intended to require an entity to present income taxes under IAS 12 in the line item of ‘tax expense’ when it published the final standard of IAS 1 (revised 1997). Please refer to Appendix C for the relevant requirements in the final standard and exposure draft of IAS 1 (revised 1997).

18. As shown below, paragraph 77 of IAS 12 requires an entity to present tax expense in the statement of comprehensive income. This requirement has not been changed since the IASC Original Standards (1975-1992) even though there have been changes in the wording of the requirement.

77 The tax expense (income) related to profit or loss from ordinary activities shall be presented as part of profit or loss in the statement(s) of profit or loss and other comprehensive income.

19. In addition, with regard to the term ‘tax expense’, paragraph 5 of IAS 12 indicates that the term ‘tax expense’ as used in IAS 1 is linked to the term ‘income taxes’ under IAS 12 (emphasis added):

5. [...]

Tax expense (tax income) is the aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax.

Current tax is the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period.

Deferred tax liabilities are the amounts of income taxes payable in future periods in respect of taxable temporary differences.

Deferred tax assets are the amounts of income taxes recoverable in future periods in respect of: [...]

20. Furthermore, even though there is no explicit reference to IAS 12 in paragraph 82(d) of IAS 1, related tax assets and liabilities that are listed in paragraph 54 of IAS 1 as line items in the statement of financial position provide explicit references to income taxes under IAS 12 as shown below (emphasis added):

54 As a minimum, the statement of financial position shall include line items that present the following amounts:[...]

(n) liabilities and assets for current tax, as defined in IAS 12 Income Taxes;

(o) deferred tax liabilities and deferred tax assets, as defined in IAS 12; [...]

21. On the basis of the analysis above of the standards in IAS 1 and IAS 12, we consider that ‘tax expense’ in IAS 1 does not include taxes that are not income taxes as defined by IAS12.

Use of plural term ‘taxation authorities’ in IAS 12

22. In this section, we analysed the use of plural term “taxation authorities” as used in the definition of taxable profit in IAS 12 in the context of determination of the scope of income taxes under IAS 12.
23. According to the submission, those who advocate View 2 argue that the definition of income taxes under IAS 12 indicates that the royalty payments to one taxation authority that are not within the scope of IAS 12, can be considered as prepayment of income taxes to another tax authority when the royalty payments are deductible against income tax payables to the latter authority. The rationale given in the submission is that the use of plural term ‘taxation authorities’ in the definition of taxable profit in IAS 12 indicates that the number of taxation authorities to which the taxes are payable is not relevant for determining whether the taxes are within the scope of IAS 12.
24. The staff agree with the view that multiple taxation authorities could be recipients of taxes that meet the definition of income taxes under IAS 12. However, we disagree with the interpretation that some non-income tax payments to an authority are considered as part of income taxes to another authority only because of the use of the plural term in the definition of taxable profit under IAS 12.
25. We understand that the submitter assumes that the royalty payments are outside the scope of IAS 12 primarily because the amount of the tax payables is determined based on the gross amount of sales revenue rather than on taxable profit for a period. With regard to the definition of income taxes, the Committee discussed the issue in March 2006 and decided not to add the issue to the agenda and issued the following agenda decision (emphasis added):

IAS 12 Income Taxes – Scope

The IFRIC considered whether to give guidance on which taxes are within the scope of IAS 12. The IFRIC noted that IAS 12 applies to income taxes, which are defined as taxes that are based on taxable profit. That implies

that (i) not all taxes are within the scope of IAS 12 but (ii) because taxable profit is not the same as accounting profit, taxes do not need to be based on a figure that is exactly accounting profit to be within the scope. The latter point is also implied by the requirement in IAS 12 to disclose an explanation of the relationship between tax expense and accounting profit. The IFRIC further noted that the term ‘taxable profit’ implies a notion of a net rather than gross amount. Finally, the IFRIC observed that any taxes that are not in the scope of IAS 12 are in the scope of IAS 37 Provisions, Contingent Liabilities and Contingent Assets.

However, the IFRIC also noted the variety of taxes that exist world-wide and the need for judgement in determining whether some taxes are income taxes. The IFRIC therefore believed that guidance beyond the observations noted above could not be developed in a reasonable period of time and decided not to take a project on this issue onto its agenda.

26. As stated in the agenda decision, an entity is required to judge whether some taxes fall within the scope of income taxes under IAS 12. In making this judgement, the entity should take into consideration relevant tax rules and legislation in the jurisdiction. We believe that this process generally involves considerations to the factors relating to authorities to which those taxes are payable.
27. In our view, however, if those taxes are determined to be outside the scope of IAS 12 because the taxes are calculated based on gross revenue, further considerations to the factors relating to the taxation authorities would no longer be relevant and cannot override the conclusion reached. As indicated in the agenda decision, whether the amounts of taxes are based on net profit or not would be a key to determining whether the taxes are within the scope of IAS 12. Even though the word of ‘taxation authorities’ is part of the definition of income taxes, that factor is not a determinant by itself.
28. Consequently, we are of the view that the use of the plural term in IAS 12 is not intended to mean that priority of consideration is to be given to taxation authorities in the judgement of the scope of income taxes.

Prepayment of income taxes

29. Proponents of View 2 admit that the non-income tax payments are considered to be separate and distinct from income tax payables to the government and the nature of the payments are not changed under the proposed MRRT.
30. Nevertheless, they argue that the characteristics and substance of the royalty payments in the context of the proposed MRRT is changed, and therefore, can be considered as, in substance, prepayment of the income taxes in that the non-income tax payments to a local taxation authority will become deductible against income taxes to the government.
31. We note, however, that a tax regime permits an entity to claim various expenses as tax deductions or tax credits against income tax payables to the extent permitted under the tax regime. An entity accounts for those expenses in accordance with applicable IFRSs apart from the tax treatment of those expenses. We do not think that there is a reasonable basis for differentiating the accounting for the royalty payments from the accounting for other expenses that are outside the scope of IAS 12, both of which may result in reducing income tax payables.
32. Once the royalty payments are determined as expenses outside the scope of IAS 12, we think that they should be accounted for in accordance with other applicable IFRSs. An entity should distinguish the accounting for expenses incurred in a transaction or event from the tax treatment of those expenses. Even though accounting expenses may become a basis for the tax treatment of the expenses under the tax regime, we think that the tax treatment should not affect what IFRSs should apply to the expenses. We therefore think that the royalty payments should be accounted for outside the scope of IAS 12 and thus separately from the MRRT, even if the tax treatment allows the entity to deduct the amount of the royalty payments from the MRRT liabilities under the tax regime. We think this conclusion applies regardless of whether the payments are made to the same or different taxation authorities.

Summary of technical analysis

33. In summary, we do not support the arguments in View 2 on the basis of the analysis above. We think that the line item of 'tax expense' in IAS 1 does not

include taxes that are outside the scope of IAS 12. In addition, in determining whether some taxes meet the definition of income taxes under IAS 12, an entity needs to make a judgement by applying the definition of income taxes in IAS 12. Even though the entity may give consideration in the judgement to the factors relating to taxation authorities, these factors do not necessarily carry more weight than other factors such as the ‘net or gross’ factor. Further, we think that it is inappropriate to conclude that non-income tax payments such as royalty payments in this case, that are deductible against income taxes, should be accounted for as prepayment of income taxes because tax treatment of the payments should not dictate the accounting for the payments.

Outreach request

34. We sent a request for information to the National Standard-Setters Group in order to help assess the Committee’s agenda criteria. Specifically, we asked:

- (a) In your jurisdiction, is there a similar tax regime with those described above? If similar, but not identical, please tell us about the differences.*
- (b) If there is a similar tax regime, what is the prevalent accounting for the payments?*
- (c) Would your view be that there is diversity in practice for these types of payments?*

35. Excerpts from the outreach request are attached as Appendix B to this paper. The request was still outstanding when this agenda paper was completed. We will provide the Committee with an update of the results of this outreach at the March Committee meeting.

Agenda criteria and staff recommendation

36. In this section, we assess the submission against the agenda criteria of the Committee as follows:

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

- (b) The issue indicates that there are significant divergent interpretations (either emerging or existing in practice).*
- (c) Financial reporting would be improved through the elimination of the diverse reporting methods.*
- (d) The issue can be resolved efficiently within the confines of existing IFRSs and the Framework, and the demands of the interpretation process.*
- (e) It is probable that the Committee will be able to reach a consensus on the issue on a timely basis.*
- (f) If the issue relates to a current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project?*

37. We are going to assess the criteria (a) to (e) once the outreach activity is completed. Any update on the assessment of the criteria will be provided at the March Committee meeting together with the update on the outreach.
38. For criterion (f), taking into consideration the Board's discussions and tentative decisions taken in relation to IAS 1 and IAS 12, we are not aware of any forthcoming amendments that would affect the issue discussed in this agenda paper. Consequently, this issue meets criterion (f).
39. Consequently, if the Committee agrees with our technical analysis as shown in paragraph 13-33, our recommendation for the next steps depends on the results of the outreach:
- (a) If it turns out that the issue satisfies the criteria of (a) to (e) in paragraph 36 of this paper, we will propose that the Committee should recommend to the Board that it should issue a clarification of the presentation requirements of non-income taxes in the form of annual improvements. In that case, we will present a proposed amendment for the annual improvements project at the March Committee meeting, which will include an assessment against the annual improvement criteria.
 - (b) If it turns out, however, that the issue does not satisfy those criteria, we will recommend that the Committee should not add the issue to its agenda.

In that case, we will present a draft tentative agenda decision at the March Committee meeting.

Questions for the Committee

Questions for the Committee

1. Does the Committee agree with our technical analysis in paragraphs 13-33?
2. Does the Committee agree with our recommendation in paragraph 39?

Appendix A1—Accounting for royalty payments claimed as an allowance against income tax payable

The staff received the following request from the **Australian Accounting Standards Board (AASB)**. All information has been copied without modification.

22 December 2011

Wayne Upton
Chairman
IFRS Interpretations Committee
30 Cannon Street
London EC4M 6 XH
United Kingdom

Dear Wayne,

IFRS IC potential agenda item request: Accounting for royalty payments claimed as an allowance against income tax payable

We wish to submit a potential agenda item for consideration by the IFRS Interpretations Committee (the “Committee”) relating to the accounting for royalty payments made to one level of government claimed as an allowance (i.e. the full amount is creditable) against income tax payable to another level of government.

Although this issue has arisen in Australia in relation to the proposed Minerals Resource Rent Tax (MRRT) and extended Petroleum Resource Rent Tax (PRRT), we believe the issue of how to account for such allowances may also be relevant to other jurisdictions internationally that have, or introduce, tax regimes with the same or similar characteristics. For example, we are aware that some jurisdictions, in endeavouring to direct private sector funding for social programs, have introduced regulations that permit charitable donations to be fully creditable against income tax payable.

In summary, the issue we are requesting the Committee to address is how production based royalties paid to one level of government that can be claimed as an allowance against an income tax payable to another level of government should be classified – as a production cost, or as an income tax? A detailed explanation of the issue, possible alternative accounting treatments and reasons for the Committee to address the issue are outlined in Appendix A to this letter.

If you require further information regarding this proposed agenda item, please contact me or Nikole Gyles (ngyles@asb.gov.au).

Yours sincerely
Kevin M. Stevenson
Chairman and CEO

Appendix A: Potential agenda item request

Issue

Under the proposed MRRT and extended PRRT in Australia¹, payments made to State Governments for production based royalties are permitted to be claimed as an allowance against MRRT/PRRT payable to the Federal Government (a separate taxation authority). The State Governments have the power to determine the level of royalty to be charged without consultation or approval of the Federal Government.

The allowance for the royalty payments for MRRT/PRRT purposes is grossed up to reflect a 100 per cent credit for the payments made. For example, if an entity has a gross MRRT liability of \$10 million, and has already paid \$3 million in production based royalties, the net MRRT liability (the amount payable to the Federal Government) would be \$7 million (\$10m-\$3m)². This is designed to avoid double-taxation for affected entities. Any royalties not utilised as allowances in one period are carried forward to future periods and uplifted each year by the Long Term Bond Rate plus a further percentage (5 per cent for PRRT and 7 per cent for MRRT).

On their own, the production based royalties do not meet the definition of income taxes in IAS 12 Income Taxes. For the purposes of this request, it should be assumed that MRRT/PRRT are considered to be income taxes within the scope of IAS 123.

How should the payments made to State Governments for production based royalties that can be claimed as an allowance against an income tax payable to the Federal Government taxation authority be accounted for?

Alternative accounting treatments

View 1: Classified as an operating/production cost

¹ The proposed MRRT and extended PRRT passed the House of Representatives on 23 November 2011. It is expected that the legislation will be debated by the Senate in March 2012. The legislation is proposed to be effective from 1 July 2012.

² Note that the mechanics of how the MRRT and extended PRRT operate have been simplified for this example. Although the net impact is the same, the mechanics of the MRRT and extended PRRT are that the royalty payments are grossed up as royalty allowances and used to reduce mining profit before calculating any MRRT/PRRT liability. Unused royalty allowances are treated in a similar way to carried forward MRRT losses.

³ Note that, following the IFRIC rejection notice in March 2006 not to provide guidance on which taxes, in various jurisdictions, are within the scope of IAS 12, the AASB is currently of the view that the proposed Australian MRRT would be an income tax within the scope of IAS 12. In 2007 the AASB issued a domestic interpretation, AASB Interpretation 1003 *Australian Petroleum Resource Rent Tax*. The consensus in AASB Interpretation 1003 is that the Australian PRRT is an income tax within the scope of AASB 112 (the Australian Accounting Standard that incorporates IAS 12). Nonetheless, the classification of the proposed Australian MRRT is not the issue requested to be addressed in this letter – the issue would apply to any tax classified as an income tax within the scope of IAS 12.

The imposition of the royalty is considered to be separate and distinct from the imposition of the MRRT/PRRT, on the basis that the imposts are levied by separate taxation authorities.

The nature of the royalty payments is not changed under the proposed MRRT/PRRT. Accordingly, those supporting view 1 are of the view that royalties should be accounted for as an operating/production cost, as they do not, in themselves, meet the definition of income taxes in IAS 12, and therefore should be included in inventory costing to the extent appropriate. Applying view 1 would result in the current income tax expense arising from MRRT/PRRT being measured as the net amount of MRRT/PRRT payable (i.e. gross MRRT/PRRT payable less royalties paid).

View 2: Classified as an income tax

IAS 12 defines taxable profit (tax loss) as ‘...the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable).’ (paragraph 5, emphasis added)

Under the proposed MRRT and extended PRRT the amounts in the form of a non-income tax paid to one taxation authority are claimed as an allowance against income taxes payable to another taxation authority. This changes the nature of the payments in the form of a non-income tax into payments that are, in substance, an income tax (or prepayment of income tax).

The use of the plural term ‘taxation authorities’ in the definition of taxable profit means that the distinction between which taxation authority the taxes are payable to is not relevant when calculating income tax payable⁴.

Although the nature of the royalty payments, considered in isolation, is not changed under the proposed MRRT/PRRT, the characteristics and substance of the payments in the context of the proposed MRRT/PRRT is changed. Accordingly, those supporting view 2 are of the view that the payment of royalties is considered to be a prepayment of MRRT/PRRT and is presented as a current tax amount following the requirements of IAS 12. Applying view 2 would result in the income tax expense arising from MRRT/PRRT being measured as the total amount of taxes payable under the MRRT/PRRT regime (i.e. net MRRT/PRRT payable plus royalties paid).

To the extent that there is sufficient MRRT/PRRT payable during the year, the royalty payment would be treated as a current tax amount and presented as part of current income tax expense as there would be sufficient MRRT/PRRT payable against which the royalties IFRS IC potential agenda item request: Accounting for royalty payments claimed as an allowance against income tax payable Page 4 of 4

⁴ The term *taxation authorities* is not defined in IFRS. The conventional reading of the term implies that the term is not limited in use to only authorities that collect income tax, as defined in IAS 12, but might also include authorities that collect taxes that are not income taxes, e.g. production based taxes.

paid could be claimed as an allowance. To the extent an entity does not have sufficient MRRT/PRRT payable during the year, the prepayment would be an asset at year-end.

Summary

In summary, the difference between the two views is about whether claiming an expense paid to one taxation authority as an allowance against income tax payable to a different taxation authority is viewed as bringing the original amount paid within the scope of IAS 12.

Reasons for IFRS IC to address the issue

Criteria	Assessment
The issue is widespread and has practical relevance.	Yes. The issue affects all entities in Australia subject to the proposed MRRT and extended PRRT. A number of these entities have international operations and IFRS reporting requirements in jurisdictions other than Australia. The issue is also likely to affect entities in other jurisdictions that have introduced similar tax regimes whereby amounts in the form of non income taxes payable to one taxation authority are claimable as an allowance against income taxes payable to another taxation authority.
The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice).	Yes. Based on outreach performed to industry participants and Big 4 accounting firms within Australia the AASB is of the view that, in the absence of further guidance, diversity in practice could arise on the introduction of the new tax regime.
Financial reporting would be improved through the elimination of the diversity.	Yes. The accounting treatment in view 1 would provide a significantly different outcome to view 2 (as illustrated in Appendix B to this letter). Therefore, eliminating or reducing the potentially diverse reporting methods would improve financial reporting.
The issue is a narrow implementation or application issue that can be resolved efficiently within the confines of existing IFRSs and the Framework for the Preparation and Presentation of Financial Statements, but not so narrow that it is inefficient to apply the interpretation process.	Yes. The issue relates to an interpretation of a specific application of IAS 12.
If the issue relates to a current or planned IASB project, there is a pressing need to provide guidance on a more timely basis than would be expected from that project.	There is no current IASB project, however, depending on the outcome of the IASB's agenda consultation, the Income Taxes project may be reactivated. There is a pressing need to provide guidance on a more timely basis than would be expected from that project as the proposed MRRT and extended PRRT are expected to be effective from 1 July 2012.

Appendix A2—Second submission - Accounting for royalty payments claimed as an allowance against income tax payable

The staff received the following request from a constituent. All information has been copied without modification.

27 February 2012

Wayne Upton
Chairman
IFRS Interpretations Committee
30 Cannon Street
London EC4M 6 XH
United Kingdom

Dear Wayne

Accounting for royalty payments claimed as an allowance against income tax payable

In December 2011 the Australian Accounting Standards Board submitted a potential agenda item for consideration by the IFRS Interpretations Committee (the "Committee") relating to the accounting for royalty payments claimed as an allowance against income tax payable. We understand that the Committee may be considering this issue at its March 2012 meeting and would like to submit our view for the Committee's consideration.

This issue arises in relation to the proposed Minerals Resource Rent Tax ("MRRT"). By way of background, the MRRT is an Australian Federal Government initiative which seeks to tax the resource rent profits attributable to the extraction of coal and iron ore in Australia. The MRRT is levied at an effective rate of 22.5% on the MRRT profit of a mining project interest. MRRT profit is calculated as mining profit less MRRT allowances. The MRRT allowances include, amongst others, a royalty allowance and a starting base allowance.¹ The MRRT allowances are required to be applied against mining profit in a particular order, beginning with the royalty allowance. An overview of the calculation of the proposed MRRT is included in an Appendix to this letter.

There is general consensus amongst the accounting community that the MRRT is an income tax within the scope of IAS 12 *Income Taxes*, although we are aware of some diversity in views as to how IAS 12 should be applied to certain aspects of the MRRT.

Mining royalties paid to Australian State and Territory governments ('State-based royalties') in relation to a mining project are claimable as a royalty allowance against any MRRT liability to the Federal Government.² The operation of the State-based royalties varies from State to State. While some royalties are levied as a percentage of gross sales revenue, others are calculated as a percentage of revenue less allowable deductions. Such arrangements are often classified as an operating cost and accounted for in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, although treatment of State-based royalties under IAS 12 has also been applied

¹ The starting base allowance recognises the past investment in assets of a mining project. A miner may elect to use either book or market value as at 1 May 2010 as the starting base for project assets.

² References to royalty payments throughout this letter are only to those royalties which are creditable against the MRRT.

by some entities depending on their chosen policy. Because these royalty payments reduce the MRRT liability the question arises as to whether they should be treated as income tax rather than an operating cost. We consider that there are three key aspects to this issue, being:

- Reclassification of royalty payments in the context of the MRRT
- Classification of royalty payments as an income tax in their own right
- Relevance and understandability to users of the financial statements

Reclassification of royalty payments in the context of the MRRT

The following points are important in understanding the substance of the MRRT arrangements and their inter-relationship with State-based royalties:

- the MRRT was initially conceived as a replacement for all State-based royalties. However, the Federal government was unsuccessful in its negotiations with the State and Territory governments and therefore designed the MRRT to provide affected taxpayers with a full credit for any State-based royalties paid in respect of a mining project (i.e. the royalties paid reduce the MRRT liability, via the royalty allowance, on a dollar-for-dollar basis);
- the royalty allowance is the first MRRT allowance to be applied against any MRRT liability. This was done with intent to ensure, as much as possible, that an entity did not bear both a royalty and a MRRT burden; and
- unused royalty credits are subject to uplift³ and carried forward to be applied against MRRT liabilities in later years. These carried forward royalty credits are included in the royalty allowance which is the first MRRT allowance to be applied against any MRRT liability in a particular period.

Whilst the implementation of the MRRT does not change the basis of the calculation of the State-based royalties, the MRRT clearly changes the character and substance of the royalties under an MRRT regime. Accordingly, the classification of the royalty payments should be determined in the context of the MRRT. More specifically, under the MRRT regime, the royalty payments effectively function as a prepayment of MRRT and no longer represent a cost to the entity. Because the MRRT is accounted for as income tax the royalty payments should also be classified as part of that income tax arrangement.

Some may argue that treating the royalty payments as a prepayment of MRRT is not appropriate because in the event that there is no MRRT liability for the period, the royalty payments are not refundable (i.e. the royalties paid can not be viewed as a prepayment of MRRT tax if there is no MRRT liability). However, as noted above, the royalty allowance is the first MRRT allowance to be applied to a MRRT liability and any unused royalty credits are carried forward to be applied to MRRT liabilities in future years. It is therefore extremely unlikely that royalty payments would not be recovered against MRRT obligations, and for this reason, we consider the treatment of royalties as a prepayment of MRRT to be the most appropriate.

Some may also argue that because the State-based royalty is payable to one taxation authority (i.e. a State Government) and the MRRT is payable to a different taxation authority (i.e. the Federal Government), it is necessary to consider them separately for the purpose of classification. Proponents of this view would argue that to the extent the royalties are considered to be an

³

Unused royalty credits are uplifted at the Long-Term Government Bond Rate (LTBR) + 7% (LTBR is approx. 6% therefore uplift factor is approx. 13% p.a.).

operating cost when considered in isolation from the MRRT, it is not appropriate to classify those royalties as income tax. However, we do not believe there is any basis to determine the accounting treatment for related taxation arrangements only because the 'counterparty' to each arrangement is different. In particular, we note that IAS 12 defines taxable profit as "the profit for a period, determined in accordance with the rules established by the *taxation authorities*, upon which income taxes are payable" (italicised for emphasis). We believe that the reference to taxation authorities 'plural' means that the payment of amounts to more than one taxation authority does not prohibit the payments from being considered on a collective basis, particularly when those payments are inter-dependent. Similar situations exist in other jurisdictions, such as the United States, where State based taxation imposts are creditable against Federal tax obligations.

In conclusion, in light of the inter-dependencies between MRRT and royalty obligations, we believe it is most appropriate to classify State-based royalties as part of the accounting for income tax arising under the MRRT,

Classification of royalty payments as an income tax in their own right

The analysis above considers whether it is appropriate to classify State-based royalties as part of the income tax accounting for MRRT, in light of the operation of the MRRT which provides a full credit for the State-based royalties paid. We believe such a classification is most appropriate. However, notwithstanding that view, we also believe it is acceptable for the State-based royalties to be classified as an income tax when considered on a stand-alone basis.

Paragraph 2 of IAS 12 states "For the purpose of this Standard, income taxes include all domestic and foreign taxes which are based on taxable profits."

As noted above, paragraph 5 of IAS 12 defines taxable profit (tax loss) as "the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable)".

Whilst these references appear circular, we note that IAS 12 does not provide any further guidance on what may be considered to be 'taxable profit (tax loss)' and therefore an 'income tax'. IFRIC considered the issue in 2006 and provided the following non-authoritative guidance:

- a) "the term 'taxable profit' implies a notion of a net rather than gross amount"; and
- b) "because taxable profit is not the same as accounting profit, taxes do not need to be based on a figure that is exactly accounting profit to be within the scope. The latter point is also implied by the requirement in IAS 12 to disclose an explanation of the relationship between tax expense and accounting profit".

In our view, IFRIC's first point that the term 'taxable profit' implies a notion of a net rather than gross amount is contrary to the requirements of IAS 12. As noted above, IAS 12 defines taxable profit (the 'assessable amount') as the amount *determined in accordance with the rules established by the taxation authorities*. To the extent that the rules established by the taxation authorities do not permit deductions in the determination of the assessable amount this should not prevent an entity from treating the tax as an income tax. This would ensure that government taxes levied on gross amounts are included within income tax expense thereby providing a better reflection of the total tax impost on the entity.

We assume that the IFRIC's guidance on this point stem from the use of the word 'profit' in the definition of taxable profit and the definition of profit or loss in IAS 1 and the Framework.⁴ However, this approach seems unworkable when different tax regimes around the world operate with intent to allow or disallow the deduction of a wide variety of 'outgoings' in determining taxable profits.

IFRIC's second point makes it clear that taxable profit is not the same as accounting profit. However, in conjunction with the first point, this raises the question as to what quantum or nature of expenses (deductions) satisfies the IFRIC's notion of a net amount for taxable profit? For example, if a taxation authority imposes a tax which is a percentage of gross sales, but permits minor 'prescribed' deductions, does this cause the tax to be included in the scope of IAS 12, compared to a tax which prohibits all such deductions?

As noted above, State-based royalties are often classified as an operating cost, particularly when they are levied on a gross amount rather than a net amount. To the extent that entities applied the definition of taxable profits within IAS 12, which requires reference to the amount *determined in accordance with the rules established by taxation authorities*, such an arrangement would be within the scope of IAS 12 and there would be no need to consider the classification of the expense in light of the implementation of the MRRT.

Relevance and understandability to users of the financial statements

Income tax accounting is without doubt a complex topic. While sophisticated users of financial statements seek greater clarity in the meaning of tax balances presented, we suspect many less sophisticated users are totally bewildered. The debate around the accounting treatment of MRRT and State-based royalties provides an opportunity to further bewilder, or preferably, to further clarify the meaning of income tax balances.

Given the clear design intent of the MRRT and the agreement between Federal, State and Territory governments to treat the MRRT and State-based royalties as one cohesive fiscal regime for the coal and iron ore mining sector, IFRIC should seek to encourage entities to present those taxes accordingly.

The treatment of State-based royalties as an integral part of the MRRT, as an in substance prepayment against an entity's MRRT obligations, ensures that the total tax impost on the entity is presented in a manner that is relevant and understandable to users of the financial statements. To do otherwise would cause the reported MRRT expense to be reduced by the significant offset of State-based royalties, for the 'cost' of that offset to be reported in pre-tax profit, but for the consequential income tax effects of both those charges to be presented in income tax expense. Such an outcome would be difficult to comprehend, difficult to explain, and fail the test of relevance to the user.

Yours sincerely

[submitter]

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IAS 1.7 defines profit or loss as "the total of income less expenses, excluding the components of other comprehensive income". Paragraph 4.60 of the Conceptual Framework states: "...profit is the residual amount that remains after expenses (including capital maintenance adjustments, where appropriate) have been deducted from income. If expenses exceed income the residual amount is a loss."

Appendix: Overview of MRRT

The following tables outline the calculation of the MRRT liability as well as key features of the proposed MRRT.⁵

Calculation of MRRT liability

Mining profit	Mining revenue (at valuation point) less mining expenditure (upstream)
Less	
MRRT Allowances (applied in this order)	Royalty allowance* Transferred royalty allowance Pre-mining loss allowance Mining loss allowance* Starting base allowance* Transferred pre-mining loss allowance Transferred mining loss allowance* *Including carried forward amounts.
X	
MRRT rate	22.5%
=	
MRRT liability	

Key MRRT features and glossary of terms

Commencement date	1 July 2012
Rate	Effective rate of 22.5% (30% headline rate less the 25% extraction allowance)
Coverage	Iron ore, coal and incidental coal seam gas projects
Mining project interest	MRRT is payable based on a 'project' (identification of project is significant because it determines how losses within projects are treated) A project consists of a single production right (it is common for a single mine to be covered by more than one production right) Rules exist for combining mining project interests (i.e. where integrated)
Taxable profits	Mining profit less MRRT allowances Mining profit = Mining revenue less mining expenditure (upstream)
Mining revenue	Value of the resource at valuation point Valuation point will generally be immediately after extraction - before the resource leaves the run-of-mine (ROM) stockpile and before any processing or value add Typically no observable price at the ROM stockpile. A 'netback' transfer pricing approach is likely to be applied whereby the final sale price to a customer is reduced for the value added in downstream activities (processing, rail, port)

⁵ Based on the MRRT bills and explanatory material introduced and passed by the House of Representatives in November 2011

Mining expenditure	<p>Costs incurred upstream of valuation point (costs of extracting resource and getting resource to valuation point)</p> <p>Includes expenditure of a revenue (but not depreciation of pre-existing assets) and capital nature (i.e. immediate deduction for eligible capital expenditure)</p> <p>Excluded costs (e.g. costs of acquiring project interests; financing costs; hire purchase and finance leases; hedging losses or foreign exchange losses)</p>
MRRT allowances	<p>Royalty allowance</p> <p>Pre-mining loss allowance</p> <p>Mining loss allowance</p> <p>Starting base allowances</p>
Royalty allowance	<p>Mining royalties paid to State's and Territories reduce MRRT liabilities for a mining project interest</p> <p>Calculated by dividing royalty by MRRT rate</p> <p>Unused royalty credits uplifted at the LTBR⁶ + 7% and applied to MRRT profits in later years</p> <p>May be transferable to other integrated project mining interests (i.e. conditions apply)</p>
Pre-mining loss allowances	<p>Expenditure incurred during the period before a mining project interest comes into existence (e.g. exploration expenditure) reduce MRRT liability for a mining project interest for a MRRT year</p> <p>Uplifted at LTBR + 7% for first 10 years then LTBR thereafter</p> <p>Transferable to other projects producing same taxable resource</p>
Mining loss allowances	<p>Occur if mining revenue less than mining expenditure</p> <p>Can be carried forward, uplifted (LTBR + 7%) and applied against mining profits in future MRRT years</p> <p>May be transferable to other project mining interests under certain conditions</p>
Starting base allowances	<p>Relate to the investments in assets of upstream mining operations of a mining project interest before 1 May 2010</p> <p>Miner may elect to use either book or market value as at 1 May 2010 as the starting base for project assets</p> <ul style="list-style-type: none"> - Market value option⁷ <ul style="list-style-type: none"> - Includes rights to resources and goodwill - Depreciated over a period of up to 25 years - Undepreciated value not uplifted - Carried forward losses uplifted by CPI - Book value option <ul style="list-style-type: none"> - Excludes rights to resources and goodwill - Depreciated over a period of up to 5 years - Undepreciated value uplifted by LTBR + 7% - Carried forward losses uplifted by LTBR + 7% <p>Eligible capital expenditure incurred between 1 May 2010 and 1 July 2012 is added to the starting base and deducted accordingly</p>
Income tax treatment	<p>MRRT payments are deductible for income tax purposes</p>

⁶ Long-term government bond rate - currently ~ 6%, therefore uplift ~ 13%

⁷ At its 9 December 2011 meeting the AASB considered a number of potential accounting issues relating to the proposed MRRT, including the accounting for the 'starting base market value uplift'. The AASB agreed the application of IAS 12 would require an entity to reflect an increase in the deductions available (resulting in future tax payments being smaller than if no uplift were to occur) as a deductible temporary difference giving rise to a deferred tax asset to the extent it meets the recognition criteria in IAS 12. As part of its deliberations the AASB considered and rejected alternative treatments including: (i) accounting for the starting base allowance as a tax holiday; and (ii) not recognising a deferred tax asset by virtue of the initial recognition exception.

Appendix B—Outreach

Dear all,

In December 2011, the IFRS Interpretations Committee received a request to clarify whether production based royalties paid to one taxation authority that are claimed as an allowance against income taxes payable to another taxation authority under a tax regime proposed in a jurisdiction should be classified as income taxes or operating cost (**Issue1**). [...]

Issue 1

The submitter states that under the proposed tax regime, payments made to a local taxation authority for production based royalties are permitted to be claimed as an allowance against income taxes payable to another party government. The royalties are grossed up by the tax rate levied by the government when calculating taxable profit for the government taxes, which results in a 100 per cent credit for the tax payables to the government. As the basis for this submission, the submitter assumes that the production based royalties are, in themselves, out of the scope of IAS 12 while the government taxes are within the scope of IAS 12. The submitter is asking the Committee to clarify whether the payments to the local taxation authority should be viewed as prepayment of income taxes payable to the government rather than separate and distinct payments to the local taxation authority.

The submitter thinks that this issue will affect not only entities in its jurisdiction subject to the proposed tax regime, but also entities in other jurisdictions that have introduced similar tax regimes in which payments to one taxation authority based on a non-income measure are claimable as an allowance against income taxes payable to another taxation authority.

For further details I have attached the relevant extracts from the submission. [...]

In the context of these requests, I would very much appreciate your observations on the following aspects of the issues:

Issue 1:

1. In your jurisdiction, do you have a similar tax regime with those described above? If similar, but not identical, please tell us about the differences.
2. If you answered yes to question one, what is the prevalent accounting for the payments?
3. Based on your response to question two, would your view be that there is diversity in practice for these types of payments?

[...] At this stage of the process I am especially interested in the observations that you have made in practice with respect to the questions above, but if you would like to provide other comments please feel free to do so.

In order to incorporate your feedback into the process for the next Committee meeting, I would appreciate receiving your input on this issue by **28 February 2012**.

If you have any questions, please do not hesitate to contact me.

Best regards,

Ken

Appendix C—Extract from IAS 1 (revised 1997)

Exposure Draft E53 *Presentation of Financial Statements*

Information to be Presented on the Face of the Income Statement

89. An enterprise's income statement should be presented in a manner which highlights the various elements of its financial performance that are necessary for a fair presentation. As a minimum, the face of the income statement should include line items which present:

- (a) revenue;**
- (b) the results of operating activities;**
- (c) the outcome of financing activities;**
- (d) the results of investing activities;**
- (e) minority interest; and**
- (f) net profit or loss for the period.**

Additional line items, headings and sub-totals should be presented on the face of the income statement when an International Accounting Standard requires it, or when such presentation is necessary to present fairly the enterprise's financial performance.

90. The income statement presentation may be amended in similar circumstances to those described in paragraph 77 in respect of the balance sheet. When a change in accounting policy is accounted for using the allowed alternative treatment in IAS 8, the income statement includes a line item for the cumulative effect of a change in accounting policy.
91. Additional line items are included on the face of the income statement where this is necessary to achieve a fair presentation of the enterprise's performance. Factors to be taken into consideration include materiality and the nature and function of the various components of income and expenses. For example, enterprises are encouraged to present the analysis in paragraph 93 on the face of the income statement.
92. Other International Accounting Standards require items to be presented on the face of the income statement. For example, IAS 8 requires profit or loss from ordinary activities and extraordinary items to be presented on the face of the income statement. IAS 12 requires the tax expense on profit or loss from ordinary activities to be presented on the face of the income statement.

IAS 1 Presentation of Financial Statements (revised 1997)***Information to be Presented on the Face of the Income Statement***

75. As a minimum, the face of the income statement should include line items which present the following amounts:

- (a) revenue;***
- (b) the results of operating activities;***
- (c) finance costs;***
- (d) share of profits and losses of associates and joint ventures accounted for using the equity method;***
- (e) tax expense;***
- (f) profit or loss from ordinary activities;***
- (g) extraordinary items;***
- (h) minority interest; and***
- (i) net profit or loss for the period.***

Additional line items, headings and sub-totals should be presented on the face of the income statement when required by an International Accounting Standard, or when such presentation is necessary to present fairly the enterprise's financial performance.

76. The effects of an enterprise's various activities, transactions and events differ in stability, risk and predictability, and the disclosure of the elements of performance assists in an understanding of the performance achieved and in assessing future results. Additional line items are included on the face of the income statement and the descriptions used and the ordering of items are amended when this is necessary to explain the elements of performance. Factors to be taken into consideration include materiality and the nature and function of the various components of income and expenses. For example, a bank amends the descriptions in order to apply the more specific requirements in paragraphs 9 to 17 of IAS 30. Income and expense items are offset only when the criteria in paragraph 34 are met.