STAFF PAPER

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IASB Meeting

Project	**Comprehensive review of the *IFRS for SMEs***		
Paper topic	Income tax		
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Purpose of this paper

1. Agenda Paper 8F (this agenda paper) asks the IASB to consider the responses received to questions in the IASB's 2012 Request for Information (RFI) on accounting for income taxes and to consider whether any amendments should be made to the *IFRS for SMEs*.

Introduction

2. There are three questions in the RFI on income tax. The staff suggest the IASB discuss these questions together:

   (a) Approach for accounting for deferred income taxes (Question S16 in the RFI and part of Issue 8 for the SME Implementation Group (SMEIG) meeting)

   (b) Consideration of exemptions from recognising deferred taxes and other differences under IAS 12 *Income Taxes* (Question S17 in the RFI and part of Issue 8 for the SMEIG meeting)

   (c) Rebuttable presumption that investment property at fair value is recovered through sale (Question S18 in the RFI and part of Issue 8 for the SMEIG meeting)

3. This agenda paper includes:

   (a) the questions asked in the RFI;

   (b) a detailed summary of the main comments received (please see Appendix B of Agenda Paper 8D for explanation of the process staff followed in summarising responses in the comment letters);

   (c) recommendations of the SMEIG and the IASB staff;

   (d) the questions for the IASB to discuss; and

   (e) an appendix containing full extract of the SMEIG recommendations on the issues in this agenda paper from the final SMEIG report.

Income tax (Issue 8: Questions S16-S18)

Question S16 in the RFI: Approach for accounting for deferred income taxes (Section 29)

Section 29 of the *IFRS for SMEs* currently requires that deferred income taxes must be recognised using the temporary difference method. This is also the fundamental approach required by full IFRSs (IAS 12 *Income Taxes*).

Some hold the view that SMEs should recognise deferred income taxes and that the temporary difference method is appropriate. Others hold the view that while SMEs should recognise deferred income taxes, the temporary difference method (which bases deferred taxes on differences between the tax basis of an asset or liability and its carrying amount) is too complex for SMEs. They propose replacing the temporary difference method with the timing difference method (which bases deferred taxes on differences between when an item of income or expense is recognised for tax purposes and when it is recognised in profit or loss). Others hold the view that SMEs should recognise deferred taxes only for timing differences that are expected to reverse in the near future (sometimes called the ‘liability method’). And still others hold the view that SMEs should not recognise any deferred taxes at all (sometimes called the ‘taxes payable method’).

Should SMEs recognise deferred income taxes and, if so, how should they be recognised?

(a) Yes—SMEs should recognise deferred income taxes using the temporary difference method (the approach currently used in both the *IFRS for SMEs* and full IFRSs).

(b) Yes—SMEs should recognise deferred income taxes using the timing difference method.

(c) Yes—SMEs should recognise deferred income taxes using the liability method.

(d) No—SMEs should not recognise deferred income taxes at all (ie they should use the taxes payable method), although some related disclosures should be required.

(e) Other—please explain.

Please provide reasoning to support your choice of (a), (b), (c), (d) or (e).

Question S17 in the RFI: Consideration of IAS 12 exemptions from recognising deferred taxes and other differences under IAS 12 (Section 29)

In answering this question, please assume that SMEs will continue to recognise deferred income taxes using the temporary difference method (see discussion in question S16).

Section 29 is based on the IASB's March 2009 exposure draft *Income Tax*. At the time the *IFRS for SMEs* was issued, that exposure draft was expected to amend IAS 12 *Income Taxes* by eliminating some exemptions from recognising deferred taxes and simplifying the accounting in other areas. The IASB eliminated the exemptions when developing Section 29 and made the other changes in the interest of simplifying the *IFRS for SMEs*.

Some interested parties who are familiar with IAS 12 say that Section 29 does not noticeably simplify IAS 12 and that the removal of the IAS 12 exemptions results in more deferred tax calculations being required. Because the March 2009 exposure draft was not finalised, some question whether the differences between Section 29 and IAS 12 are now justified.

Should Section 29 be revised to conform it to IAS 12, modified as appropriate to reflect the needs of the users of SME financial statements?

(a) No—do not change the overall approach in Section 29.

(b) Yes—revise Section 29 to conform it to the current IAS 12 (modified as appropriate for SMEs).

(c) Other—please explain.

Please provide reasoning to support your choice of (a), (b) or (c).

Question S18 in the RFI: Rebuttable presumption that investment property at fair value is recovered through sale (Section 29)

In answering this question, please also assume that SMEs will continue to recognise deferred income taxes using the temporary difference method (see discussion in question S16).

In December 2010, the IASB amended IAS 12 to introduce a rebuttable presumption that the carrying amount of investment property measured at fair value will be recovered entirely through sale.

The amendment to IAS 12 was issued because, without specific plans for the disposal of the investment property, it can be difficult and subjective to estimate how much of the carrying amount of the investment property will be recovered through cash flows from rental income and how much of it will be recovered through cash flows from selling the asset.

Paragraph 29.20 currently states:

"The measurement of deferred tax liabilities and deferred tax assets shall reflect the tax consequences that would follow from the manner in which the entity expects, at the reporting date, to recover or settle the carrying amount of the related assets and liabilities."

Should Section 29 be revised to incorporate a similar exemption from paragraph 29.20 for investment property at fair value?

(a) No—do not change the current requirements. Do not add an exemption in paragraph 29.20 for investment property measured at fair value.

(b) Yes—revise Section 29 to incorporate the exemption for investment property at fair value (the approach in IAS 12).

(c) Other—please explain.

Please provide reasoning to support your choice of (a), (b) or (c).

Responses from comment letters

Question S16

4. Approximately 55% of comment letters responding to Question S16 support SMEs recognising deferred income taxes using the temporary difference method (choice (a) —the approach currently used in both the *IFRS for SMEs* and full IFRSs). The reasons given are similar to the reasons given for aligning the *IFRS for SMEs* with new and revised IFRSs (see Appendix B in Agenda Paper 8C (Issue 4)). Additional reasons given include:

   (a) The temporary difference method provides useful information to users of the financial statements.

   (b) In many jurisdictions SMEs have been applying a temporary difference approach for a long time. Consequently, preparers and users of SME financial statements understand it. There is significant implementation experience and education material in these jurisdictions for SMEs around the world to refer to.

   (c) The temporary difference method is generally understandable and not too complicated for the SME market. Tax balance sheets are available in many cases.

   (d) Replacing the temporary difference method with either the timing difference method or the liability method is unlikely to result in any improvement as both methods are complex and involve judgement. Plus this would result in further divergence from full IFRSs.

5. Approximately 20% of comment letters responding to Question S16 believe SMEs should not recognise deferred income taxes at all, ie they should use the taxes payable method (choice (d)), although some related disclosures should be required. The following points cover the main reasons given:

(a) The taxes payable method is simple to understand and apply by preparers and users of financial statements. It would allow users of financial statements to easily see the amount of tax payable by the SME and providing a significant time and cost saving for SMEs.

(b) It is possible to provide stakeholders with information about the entity's income taxes in the notes to the financial statements without requiring the temporary difference model. For example, disclosures explaining the change in the effective tax rate year over year (to understand why tax rate is fluctuating) and the implications of temporary differences that will affect the amount paid to/recovered from the tax authorities.

(c) The temporary difference method is too complex for SMEs and errors are frequently made, reducing the quality of the financial information. The benefits of deferred tax information for users of financial statements has been shown to be questionable and many users do not understand the information provided.

(d) Particularly for entities that are small in size the costs of recognising deferred tax outweigh the benefits to users of their financial statements.

6. There was very limited support for other methods (approximately 5%), eg the timing difference method or liability method (choice (b,c)). Approximately 20% of comment letters responding to Question S16 chose (e) "other". Other suggestions made by comment letters include:

(a) Other methods such as the taxes payable method and the timing difference method may be simpler and more understandable than the temporary difference method. However, before such a significant change is made to the *IFRS for SMEs*, the costs and benefits of the different methods should be assessed from the perspective of SMEs and users of their financial statements. Further outreach and field testing should be performed. Until this is done the temporary difference model should be retained.

(b) When considering whether alternative approaches to income tax should be considered for SMEs, the IASB should consider the work done by the European Financial Reporting Advisory Group (EFRAG) and the UK standard setter, the UK Accounting Standards Board (ASB), in particular the Discussion Paper *Improving the Financial Reporting of Income Tax*.

(c) Permit SMEs an option of either using the temporary difference method or the taxes payable method.

(d) A timing difference plus approach is used in the UK version of the *IFRS for SMEs*.

Question S17

7. Question S17 assumed that SMEs will continue to recognise deferred income taxes using the temporary difference method. Only about 10% of comment letters responding to Question S17 thought that there was no need to revise the overall approach in Section 29 (choice (a)). The reasons given include Section 29 not causing problems in practice and it being difficult to simplify IAS 12 sufficiently for SMEs.

8. Approximately 75% of comment letters responding to Question S17 would revise Section 29 to conform it to the current IAS 12 modified as appropriate to reflect the needs of the users of SME financial statements (choice (b)). The reasons given are similar to the reasons given for aligning the *IFRS for SMEs* with new and revised IFRSs (see Appendix B in Agenda Paper 8C (Issue 4)). Additional reasons include:

(a) Section 29 does not simplify the approach in IAS 12. Consequently, it would be better to align Section 29 with full IFRSs to avoid unnecessary differences with full IFRSs rather than base it on an exposure draft that was never finalised.

(b) It could be argued Section 29 is more complex than IAS 12 because the removal of the IAS 12 exemptions results in more deferred tax calculations being required.

(c) Section 29 should be revised for the same reasons that the March 2009 exposure draft was rejected.

(d) IAS 12 has been applied by entities, including SMEs, for many years and so it is better understood than the approach in Section 29. If Section 29 is revised to conform it to the current IAS 12, SMEs may use the experience of entities currently applying the requirements under full IFRSs and the extensive education material on IAS 12 to help them understand the requirements. It is more difficult to transfer this experience and knowledge to SMEs when requirements are not similar to IAS 12.

(e) A number of jurisdictions have replaced Section 29 by the recognition and measurement requirements in IAS 12 when adopting their own version of the *IFRS for SMEs*.

9. Approximately 15% of comment letters responding to Question S17 chose (c) “other”. Most of these comment letters chose not to answer Question S17 directly. Instead they emphasised that both Section 29 and IAS 12 are too complex for SMEs.

Question S18

10. Question S18 assumed that SMEs will continue to recognise deferred income taxes using the temporary difference method. Approximately 15% of comment letters responding to Question S18 think the overall approach in Section 29 should be left unchanged (choice (a)). However, approximately 75% would revise Section 29 to incorporate a rebuttable presumption that the carrying amount of investment property measured at fair value will be recovered entirely through sale (choice (b)). Question S18 asks whether the *IFRS for SMEs* should incorporate revisions made to IAS 12 in December 2010. Therefore, comments received were similar to those on incorporating new and revised IFRSs (see Appendix B in Agenda Paper 8C (Issue 4)). However, there was slightly more support for incorporating a rebuttable presumption under Question S18 than for other changes in new and revised IFRSs. This is because many respondents felt that such a rebuttable presumption is consistent with the aim of the *IFRS for SMEs* because it would result in a simplification for SMEs. Some respondents noted that that many entities have adopted the amendment to IAS 12 early and it has proven to be

useful. Approximately 10% of comment letters responding to Question S18 chose (c) “other”. Most of these comment letters chose not to answer Question S17 directly. Instead they emphasised that both Section 29 and IAS 12 are too complex for SMEs.

Staff comments

Differences between the IFRS for SMEs and IAS 12

11. The *IFRS for SMEs* follows the approach set out in the Board’s ED Income Tax, published in March 2009. This main differences between Section 29 of the *IFRS for SMEs* and IAS 12 are:

(a) Tax basis.

(i) Section 29 requires the tax basis of an asset to be determined based on recovery through sale.

(ii) IAS 12 requires the tax basis to be determined depending upon how the entity expects to recover the carrying amount of an asset.

(b) **Initial recognition exemption**.

(i) Section 29 does not have the initial recognition exception that is contained in IAS 12.

(ii) IAS 12 has an initial recognition exception that prohibits an entity from recognising deferred tax assets and liabilities that arise when an asset or liability has a tax basis different from its initial carrying amount, except in a business combination or in a transaction affecting accounting or taxable profit.

(c) **Exceptions for deferred tax arising from investments in subsidiaries, branches, associates and joint ventures:**

(i) The *IFRS for SMEs* restricts the exception to investments in foreign subsidiaries, associates, joint ventures or branches that are essentially permanent in duration.

(ii) IAS 12 restricts the exception to where the investor is able to control the timing of the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.

(d) Recovery of deferred tax assets:

(i) Under Section 29 deferred tax assets are recognised in full, less, if applicable, a valuation allowance.

(ii) IAS 12 has a single-step recognition requirement for the portion of a deferred tax asset for which realisation is probable.

(e) Uncertainty over tax amounts:

(i) Under Section 29 current and deferred tax assets and liabilities are measured using the probability-weighted average amounts of possible outcomes assuming that the tax authorities will examine the amounts.

(ii) IAS 12 is silent.

Reasoning for the current approach

12. Paragraphs BC121, BC122 and BC145 in the Basis for Conclusions accompanying the *IFRS for SMEs* contain the IASB's reasoning for choosing the current approach for income taxes:

BC121 In their responses to the questionnaire and at the round-table meetings, many preparers and auditors of SMEs' financial statements said that the temporary difference approach to accounting for income taxes in IAS 12 *Income Taxes* is difficult for SMEs to implement. They said that SMEs do not routinely prepare 'tax balance sheets' and generally do not track the tax bases of many assets. Some advocated a 'current taxes payable' method of accounting for income taxes, under which SMEs would not recognise deferred taxes.

BC122 The Board did not support the 'current taxes payable' approach for the reasons explained in paragraph BC145. However, while believing that the principle of recognising deferred tax assets and liabilities is appropriate for SMEs, the Board also concluded that implementation of that principle could be simplified for SMEs. Section 29 *Income Tax* of the *IFRS for SMEs* uses the approach set out in the Board's exposure draft *Income Tax*, published in March 2009, which proposes a simplified replacement for IAS 12. The only significant measurement difference in the *IFRS for SMEs* as compared with the exposure draft *Income Tax* is where a different tax rate applies to distributed and undistributed income. The *IFRS for SMEs* requires current and deferred taxes to be measured initially at the rate applicable to undistributed profits, with adjustment in subsequent periods if the profits are distributed. The *Income Tax* exposure draft would initially measure current and deferred taxes at the tax rate expected to apply when the profits are distributed.

BC145 Some support the 'taxes payable method' of accounting for income taxes. Under that method, only income taxes currently payable or refundable are recognised; deferred taxes are not recognised. Many users of SMEs' financial statements disagree with the taxes payable method. They point out that deferred taxes are liabilities (or sometimes assets) that can result in large outflows (inflows) of cash in the near future and, therefore, should be recognised. Even those users of financial statements who do not agree that deferred tax liabilities or deferred tax assets should be recognised generally want the amounts, causes and other information disclosed in the notes. Note disclosure would entail the same tracking and computation effort for SMEs as would recognition, but would be inconsistent with the principles for recognising assets and liabilities in the *Framework*. The Board concluded that making a fundamental departure from the recognition principles in IAS 12 while requiring disclosure of the information that users of SMEs' financial statements find useful is not justified on a cost-benefit basis. Moreover, the Board believes that deferred taxes satisfy the requirements for recognition as assets and liabilities and can be measured reliably.

SMEIG recommendation

The majority of SMEIG members recommend that Section 29 should be aligned with IAS 12.

A small minority of SMEIG members recommend requiring a taxes payable approach with additional disclosure requirements for cost-benefit reasons.

An even smaller minority recommend a temporary difference approach with an undue cost or effort exemption (fallback to the taxes payable method).

Further, the SMEIG recommends that the amendment to IAS 12 to add a rebuttable presumption that the carrying amount of investment property measured at fair value will be recovered entirely through sale should be incorporated in Section 29. This is because entities applying full IFRSs have found the amendment to be a simplification and reduce subjectivity.

Staff recommendation

Overall approach (Questions S16&S17)

13. There is significant support from respondents for retaining a temporary difference approach and basing Section 29 on IAS 12. Therefore, the staff generally agree

with the SMEIG and recommend Section 29 is revised to conform it to IAS 12, modified as appropriate to reflect the needs of users of SME financial statements. Staff think it would be better to base Section 29 on the approach in IAS 12, rather than on an exposure draft that was never finalised. In many jurisdictions IAS 12 has been applied by entities, including SMEs, for years. SMEs may use this experience and the education material available to understand the requirements if they are based on IAS 12.

14. On the other hand, many SMEs and users of their financial statements are not familiar with the approach in IAS 12. Many SMEs would find it costly and complex to apply an approach based on IAS 12 even using the experience of other entities around the world. Therefore whilst staff recommend Section 29 is revised to conform it to IAS 12 (modified accordingly), staff would like to explore further ways of introducing a simplification for these SMEs.

15. As explained in Agenda Paper 8D, in general the staff does not support adding accounting policy options to the *IFRS for SMEs*. Consequently staff does not propose including an option for entities to apply a simpler approach, eg the taxes payable method. However, staff would like the IASB to discuss whether it would be workable to add an undue cost or effort exemption for some or all the requirements in Section 29 (revised to align with IAS 12) as suggested by a small minority of SMEIG members. For example, if an SME cannot apply the requirements in Section 29 without undue cost or effort it would be permitted to apply a taxes payable approach (or tax payable plus approach) with additional disclosures, eg of the implications of temporary differences that will affect the amount paid to the tax authorities.

16. Exemptions for 'undue cost or effort' are already used in many sections of the *IFRS for SMEs*—for example measurement of investment property at fair value (paragraph 16.7 of the *IFRS for SMEs*), use of the projected unit credit method to measure the defined benefit obligation (paragraph 28.18) and recognition of deferred tax assets and liabilities on first-time adoption of the *IFRS for SMEs* (paragraph 35.10(h)).

Rebuttable assumption for investment property (Questions S18)

17. The staff agree with the SMEIG recommendation. The staff believe that this comprehensive review should focus on fixing implementation issues and only making essential changes. However the staff believe that this would include changes that respond to a need for SMEs or simplify existing requirements (see staff analysis in Agenda Paper 8C).

18. In line with this recommendation, the staff recommend that the recent amendment to IAS 12 to add a rebuttable presumption that the carrying amount of investment property measured at fair value will be recovered entirely through sale should be incorporated for two reasons:

    (a) Many entities applying full IFRSs have adopted the amendments early and found that the rebuttable presumption results in a simplification and reduces subjectivity (positive implementation experience is available).

    (b) If Section 29 is revised to conform it to IAS 12, it makes sense to include all amendments at the same time. This will avoid amending Section 29 again at the next three-yearly review.

19. In summary staff recommend that Section 29 is aligned with IAS 12 (including adding a rebuttable presumption for investment property at fair value), modified as appropriate to reflect the needs of users of SME financial statements. The staff would also like the IASB to consider ways of providing relief from the full requirements, eg allowing a tax payable approach with disclosure if applying the full requirements result in undue cost or effort.

Questions for the IASB
1) Should SMEs recognise deferred income taxes and, if so, how? **Assuming a temporary difference approach is followed for SMEs:** **2) Should Section 29 be revised to conform it to IAS 12, modified as appropriate to reflect the needs of the users of SME financial statements?** **3) Should Section 29 include an 'undue cost or effort' exemption for some or all of its requirements?** **4) Should Section 29 be revised to incorporate a rebuttable presumption that the carrying amount of investment property measured at fair value will be recovered entirely through sale?**

Appendix A: Extract from near final draft of the SMEIG (Issue 8)

Issue 8) Accounting for income tax

A1. Should Section 29 Income Tax be revised?

The majority of SMEIG members recommend that Section 29 should be aligned with IAS 12.

A small minority of SMEIG members recommend requiring a taxes payable approach with additional disclosure requirements for cost-benefit reasons.

An even smaller minority recommend a temporary difference approach with an undue cost or effort exemption (fallback to the taxes payable method).

Further, the SMEIG recommends that the amendment to IAS 12 to add a rebuttable presumption that the carrying amount of investment property measured at fair value will be recovered entirely through sale should be incorporated in Section 29. This is because entities applying full IFRSs have found the amendment to be a simplification and reduce subjectivity.

SMEIG discussion

A2. The SMEIG noted the complexity of applying IAS 12, however some members also acknowledged the economic validity of recognising deferred tax. Members further noted that the earlier recommendation to revalue PPE further emphasised a requirement for a deferred tax type recognition.

A3. On balance, a majority of SMEIG members supported a proposal that *IFRS for SMEs* be amended to align with the principles of IAS 12. These members argued that deferred taxation provides important and relevant information about an entity, and agreed with the basic economic rationale for the deferred tax treatment. Whilst acknowledging the flaws and complexities of IAS 12, they felt that it was operating in practice, and that many practitioners were comfortable with it. These members stressed the importance of alignment with full IFRSs.

A4. A minority of SMEIG members, whilst acknowledging the economic rationale for deferred tax, supported a tax payable model. These members placed more emphasis on the simplicity and verifiability of the tax payable model, and less on the relevance of the deferred tax model. They feel the benefits of deferred tax information are questionable and that many users do not understand the information provided.

A5. A smaller minority acknowledged both views set out above, and believed these could be reconciled by requiring alignment with IAS 12, but with an undue cost and effort override.