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STAFF PAPER

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Project	**IFRS Interpretations Committee work in progress**		
Paper topic	IAS 12 *Income Taxes*—Recognition of deferred tax for a single asset in a corporate wrapper—Appendix A—Alternative proposals and consultations with IASB members and staff recommendation		
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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*.

Alternative proposals and consultations with IASB members

1. The Interpretations Committee asked the staff to analyse whether the requirements in IAS 12 should be amended in a limited scope project that would address the concerns raised by commentators in the course of the project.

2. Accordingly, we developed three proposals to amend IAS 12 and discussed them in various meetings in December 2013 as part of the consultation with the IASB members on the issue.

3. **For each proposal we listed pros and cons and analysed to what extent they respond to the concerns raised. However, this does not mean that we, the staff, agree with the concerns raised** (see paragraphs 28-59 of Staff Paper 3).

4. The three proposals are:

   (a) **Proposal 1 (Expected manner of recovery):** consider the expected manner of recovery not only when measuring deferred tax assets and deferred tax liabilities but also when assessing the recognition of deferred tax assets and deferred tax liabilities. Only recognise a deferred tax asset or a deferred tax liability if the expected manner of recovery of the asset results in a corresponding reduction of tax payments for or a tax payment by the parent's group.

(b) **Proposal 2 (Unit of account):** consider the asset inside and the entity housing it as one unit of account that is characterised by the asset inside for all IFRS financial statements (ie consolidated and separate financial statements), if all of the following conditions are met:

(i) the entity houses only one asset and has only (contingent) liabilities that are linked to (the ownership of) the asset inside itself; for example, a legal obligation on the owner of land to remove soil contamination;

(ii) the asset inside is measured at fair value;

(iii) the asset inside is usually bought and sold in the jurisdiction by buying and selling the shares in the entity housing it; and

(iv) the parent expects to recover the carrying amount of the asset inside by selling the shares in the subsidiary or assumes this on the basis of a rebuttable assumption.

(c) **Proposal 3 (Measurement of a discounted basis):** measure deferred tax assets and deferred tax liabilities related to investment property (ie the asset inside) on a discounted basis, if the investment property is subsequently measured at fair value. This would be a limited exception to paragraph 53 of IAS 12 only for investment property measured at fair value. The issue is particularly relevant for the investment property sector. We expect this proposal to result in significant reductions of the carrying amounts of deferred tax liabilities related to investment property, because the periods for recovering the carrying amount of the investment property are usually very long and the tax base of these assets is usually cost.

5. The application of these proposals is illustrated in Appendix A.

Proposal 1 (Expected manner of recovery)

6. Consider the expected manner of recovery not only when **measuring** deferred tax assets and deferred tax liabilities but also when assessing the **recognition** of deferred tax assets and deferred tax liabilities. Only recognise a deferred tax assets or a deferred tax liability if the expected manner of recovery of the asset

results in a corresponding reduction of tax payments for, or a tax payment by, the parent's group.

Current IAS 12

7. The expected manner of recovery is only relevant for the measurement of deferred tax assets and deferred tax liabilities, not for their recognition:

    (a) an entity recognises deferred tax assets and deferred tax liabilities on both the asset inside and the shares on the assumption that it recovers the carrying amount of both (see the Objective and paragraphs 11, 16 and 38 of IAS 12); and

    (b) if, on the basis of this assumption, the measurement of deferred tax assets and deferred tax liabilities differs depending on the manner of recovery, the entity measures deferred tax using the tax rate and the tax base that results from the entity's expectation of the manner of recovery (see paragraphs 51-51A of IAS 12).

Proposal responds to the following concerns raised

8. The proposal avoids recognising (parts of) deferred tax liabilities that are not expected to result in tax payments (by the parent's group). This approach does not result in the recognition of the deferred tax related to the asset inside unless this reflects the expected manner of recovery.

9. The determination of the tax base reflects management's intention.

10. Not distinguishing between the asset inside and the shares in the entity reflects the commercial substance of an investment that is a single asset housed on a corporate wrapper.

Pros

11. The proposal avoids a perceived overstatement of deferred tax assets and deferred tax liabilities related to investment property, which results in particular from the fact the deferred tax assets and deferred tax liabilities are measured on an undiscounted basis.

Cons

12. Only accounting for the deferred tax assets and deferred tax liabilities related to shares might result in an incomplete accounting for tax effects (refer to paragraphs 39-46 and 50-52 of Staff Paper 3).

13. This proposal is inconsistent with the 'entity concept' in IFRS 10, which requires including all liabilities in the consolidated financial statements that one entity of the group has to a party outside the group (reference is made to paragraphs 32-38 of Staff Paper 3).

14. For consistency, the approach should apply to all deferred tax assets and deferred tax liabilities and limiting the scope of the amendment would therefore be a problem. We think addressing all deferred tax assets and deferred tax liabilities would be beyond the scope of the work that the Interpretations Committee could do on behalf of the IASB. This is because comprehensive outreach would be required to assess the proposal's impact and practicability.

Proposal 2 (Unit of account)

15. Consider the asset inside and the entity housing it as one unit of account that is characterised by the asset inside for all IFRS financial statements (ie separate and consolidated financial statements), if all of the following conditions are met:

    (a) The entity houses only one asset and has only (contingent) liabilities that are linked to (the ownership of) the asset inside itself; for example, a legal obligation on the owner of land to remove soil contamination.

    (b) The asset inside is measured at fair value.

    (c) The asset inside is usually bought and sold in the jurisdiction by buying and selling the shares in the entity housing it.

    (d) The parent expects to recover the carrying amount of the asset inside by selling the shares in the subsidiary or assumes this on the basis of a rebuttable assumption.

Current IFRS 10 and IAS 12

16. The subsidiary that holds the asset inside is consolidated (see paragraph B86 of IFRS 10).

17. The parent shows in its consolidated financial statements both the deferred tax related to the asset inside and the deferred tax related to the shares, if:

    (a) tax law attributes separate tax bases to both the asset inside and to the shares (see paragraphs 11 and 38 of IAS 12); and

    (b) no specific exceptions in IAS 12 apply.

Proposal responds to the following concerns raised

18. The proposal avoids recognising (parts of) deferred tax liabilities that are not expected to result in tax payments (by the parent's group). The tax effects arising on the subsidiary level are included in the fair value/carrying amount of the unit of account. This is because the tax effects arising on the subsidiary level are realised within the unit of account and therefore impact its value.

19. Not distinguishing between the asset inside and the shares in the entity reflects the commercial substance of the investment.

20. The determination of the tax base reflects management's intention, because it is a prerequisite of this proposal that the parent expects to recover the carrying amount of the asset inside by selling the shares in the subsidiary or assumes this on the basis of a rebuttable presumption.

Pros

21. The proposal removes the measurement inconsistency between the asset inside measured at fair value and its related deferred tax assets and deferred tax liabilities. All items, including the tax effects, arising on the subsidiary level are included in the fair value/carrying amount of the unit of account (ie the shares) and are therefore subject to the same measurement basis.

22. The proposal results in accounting for the substance of the investment, which is the asset inside, rather than distinguishing between the asset inside and the shares in the entity.

23. The proposal would allow also applying the rebuttable presumption in paragraph 51C of IAS 12 introduced by *Deferred Tax: Recovery of Underlying Assets* (Amendments to IAS 12), issued in December 2010 to the unit of account. This would result in a consistent accounting, irrespective of whether the investment property is held directly by the parent of through a subsidiary.

Cons

24. The proposal might result in accounting arbitrage because:
    (a) the accounting would require significant judgement (for example, whether an asset inside is usually bought and sold in a jurisdiction by buying or selling the shares in the entity housing it); and
    (b) accounting differs depending on many specific requirements, including accounting policy choices, for example, the subsequent measurement of investment property at fair value or at cost.

25. The scope of the unit of account would be critical: for example, should be unit of account still apply if the subsidiary has a mortgage resulting from the acquisition of the investment property or if the subsidiary has obligations to pay taxes that are related to ownership of the investment property?

Proposal 3 (Measurement on a discounted basis)

26. Measure deferred tax assets and deferred tax liabilities related to investment property (ie the asset inside) on a discounted basis, if the investment property is subsequently measured at fair value. This would be a limited exception to paragraph 53 of IAS 12 only for investment property measured at fair value. The issue is particularly relevant for the investment property sector. We expect this proposal to result in significant reductions of the carrying amounts of deferred tax liabilities related to investment property, because the periods for recovering the carrying amount of the investment property are usually very long and the tax base of these assets is usually cost.

Current IAS 12

27. Paragraph 53 of IAS 12 requires measuring deferred tax assets and deferred tax liabilities on an undiscounted basis.

The proposal responds to the following concerns raised

28. The proposal responds to the general concern that the application of IAS 12 results in significant overstatement of deferred tax liabilities related to investment property housed in a single asset entity and therefore in an incorrect presentation of the statement of financial position.

Pros

29. The proposal reduces the measurement inconsistency between investment property measured at fair value, and their related deferred tax assets, and deferred tax liabilities.

30. The limited exception for investment property measured at fair value would mitigate the significant effects from deferred tax accounting for property companies. Effects that many consider inappropriate.

31. The prohibition on discounting deferred tax assets and deferred tax liabilities is not because of conceptual reasons. It was concerns about practicality that led to paragraph 53 of IAS 12 (see paragraph 54 of IAS 12).

Cons

32. There is no conceptual reason for only discounting deferred tax assets and deferred tax liabilities related to investment property.

33. We think that changing the measurement of all deferred tax assets and deferred tax liabilities to a discounted basis is, however, beyond the scope of work that the Interpretations Committee could do on behalf of the IASB. This is because comprehensive outreach would be required to assess the proposal's impact and practicability.

Feedback from consultations with IASB members

34. We consulted IASB members on the issue in various meetings in December 2013.

35. The feedback that we received from the consultations can be summarised as follows:

    (a) The vast majority of the IASB members consulted expressed a view that IAS 12 requires the accounting that the Interpretations Committee has identified.

    (b) Furthermore, the vast majority of IASB members did not express support for any of the alternative proposals reproduced in this Staff Paper or indeed for amending the principles in IAS 12 in a limited-scope project at all.

    (c) None of the IASB members consulted saw the option of addressing the concerns raised by amending IAS 12 within the confines of the existing fundamental principles of IAS 12 as being feasible.

    (d) Many IASB members expressed the view that addressing the concerns raised would only be possible after reconsidering and amending the fundamental principles in IAS 12 and such work would require a wider-scope IASB project.

    (e) During our consultations, the vast majority of IASB members expressed the view that it makes sense to account for the tax effects related to the asset inside and to the shares in the subsidiary, if tax effects can arise on both levels.

    (f) Furthermore, most of them noted that the accounting for deferred tax assets and deferred tax liabilities related to the investment property must be consistent with its fair value measurement. In other words, tax effects are either reflected in the fair value measurement of the asset inside or by recognising deferred taxes related to the asset inside. Double counting of certain tax effects as well as omitting deferred taxes related to the asset inside that are not reflected in the fair value of the asset inside should be avoided.

(g) Only a very few IASB members supported the view that the recognition of deferred tax assets and liabilities should be based on the expected manner of recovery.

Staff recommendation

36. The Interpretations Committee asked us to analyse whether the principles in IAS 12 should be amended in a limited scope project to amend IAS 12 in order to address the concerns raised by commentators in the course of our work on the issue.

37. After analysing the concerns raised by commentators, analysing proposals to amend IAS 12 and consulting with IASB members, we think that the concerns raised by commentators cannot be addressed in a limited scope project to amendment IAS 12 within the confines of the existing fundamental principles in IAS 12. We think that they require a wider-scope IASB project.

38. We reach this conclusion on the basis of the following reasons:

    (a) The analysis of the concerns raised did not clearly indicate that the requirements in IAS 12 should be amended to address the concerns raised. There are significant arguments that support the existing accounting requirements in IAS 12. The analysis highlighted pros and cons of both the accounting required by IAS 12 and an accounting that responds to the concerns raised.

    (b) We do not think that a proposal to amend IAS 12 can be developed within the confines of the existing fundamental principles in IAS 12 that combines the benefits of both the accounting required by IAS 12 and an accounting that responds to the concerns raised.

39. Because we do not have such a proposal available and do not think that such a proposal could be developed in a limited scope project to amend IAS 12, we do not think that the Interpretations Committee should recommend such a project to the IASB. We rather recommend that the Interpretations Committee refers the

concerns raised by commentators to the research project of the IASB on income taxes.

Questions for the Interpretations Committee

Questions for the Interpretations Committee
2. Do the Interpretations Committee members have any questions or comments on the information and analysis presented in this Staff Paper? 3. Does the Interpretations Committee agree with the staff recommendation that it should not take the issue onto its agenda and refer the concerns raised to the IASB research project on income taxes? If not, what alternative do you propose? 4. Does the Interpretations Committee have any comments on the proposed wording for the tentative agenda decision in Appendix B?

Appendix A—Illustration of the application of the requirements in IAS 12 and the alternative proposals

A1. Appendix A illustrates the application of the requirements in IAS 12, as identified by the Interpretations Committee, and the alternative proposals presented in this Staff Paper.

Illustrative example–Accounting required by IAS 12 Income Taxes*–as identified by the IFRS Interpretations Committee*

A2. We want to illustrate the accounting required by IAS 12 *Income Taxes* as identified by the IFRS Interpretations Committee (the 'Interpretations Committee') using the following example:

Fact pattern

Parent A holds all the shares in Subsidiary B, whose sole asset is an investment property. Subsidiary B does not constitute a business and has no other assets or liabilities. Parent A uses the fair value model in IAS 40 *Investment Property* to measure the investment property in its consolidated financial statements. The carrying amount of the investment property in the consolidated financial statements of Parent A is CU300.[1] The share of Parent A in the net assets of Subsidiary B, excluding deferred taxes, is CU300 as well.

Parent A and Subsidiary B file separate tax returns. When Subsidiary B recovers the carrying amount of the investment property, an amount of CU100 will be deductible in the tax return of Subsidiary B. When Parent A recovers the carrying amount of its investment in Subsidiary B, an amount of CU200 will be deductible in the tax return of Parent A.

The tax rate that applies to the taxable income of Subsidiary B is 30 per cent, whereas a tax rate of 10 per cent applies to the capital gains of Parent A. Parent A expects to sell the shares in Subsidiary B in the foreseeable future.

[1] In these examples monetary amounts are denominated in 'currency units' (CU).

Technical analysis

The tax base of the investment property is CU100 because Subsidiary B will deduct that amount in its separate tax filing if it recovers the carrying amount of the investment property. The taxable temporary difference relating to the investment property is CU200 (CU300 – CU100). The resulting deferred tax liability is measured by applying the tax rate of 30 per cent applicable to the taxable income of Subsidiary B. That deferred tax liability is a liability of Subsidiary B, and would be one of the identifiable liabilities acquired by any entity that acquires Subsidiary B from Parent A.

The tax base of Parent A's investment in Subsidiary B is CU200 because Parent A will deduct that amount in its separate tax filing if it recovers the carrying amount of the investment by selling the shares in Subsidiary B (see paragraph 11 of IAS 12). The share of Parent A in the net assets of Subsidiary B, including deferred taxes, is CU240 (CU300 – CU60). The taxable temporary difference relating to the investment in Subsidiary B is CU40 (CU240 – CU200). The deferred tax liability relating to the investment in Subsidiary B is measured at the tax rate applicable to the capital gains of Parent A, which is 10 per cent.

The tax base of the investment property in the consolidated financial statements is CU100 and the tax rate applicable for measuring the deferred tax liability relating to the investment property is 30 per cent, even if it is common in the jurisdiction where the investment property is located to buy or sell investment property by buying or selling the shares in the entity that holds the investment property, and even if Parent A expects to recover the carrying amount of the investment property by selling its shares in Subsidiary B.

Parent A recognises the deferred tax liability arising within Subsidiary B in relation to the investment property, regardless of whether Parent A expects to sell its investment in Subsidiary B before Subsidiary B will recover the carrying amount of the investment property. If Parent A sells its shares in Subsidiary B, the acquirer will acquire not only the investment property but also the deferred tax liability.

Parent A recognises the deferred tax liability relating to its investment in Subsidiary B, because it is probable that the temporary difference relating to the investment in Subsidiary B will reverse in the foreseeable future (see paragraph 39 of IAS 12).

Thus, Parent A recognises in its consolidated financial statements a deferred tax liability of CU60 relating to the investment property held by Subsidiary B and a deferred tax liability of CU4 relating to the investment in Subsidiary B.

Illustrative example—Proposal 1: Expected manner of recovery

A3. We want to illustrate the accounting resulting from Proposal 1–expected manner of recovery using the following example:

Fact pattern

The fact pattern is the same as in the scenario 'Accounting required by IAS 12 *Income Taxes*'. In addition, Parent A expects to sell the shares in Subsidiary B in the foreseeable future for at least CU300.

Technical analysis

Parent A recognises the deferred tax liability of CU4 related to the shares in Subsidiary B because it expects to recover the carrying amount of the investment property by selling the shares in Subsidiary A.

Parent A does not recognise the deferred tax liability of CU60 relating to the investment property although it expects to recover parts of its carrying amount by using it, ie by achieving rental income. This relates to the period before selling the shares in Subsidiary B. Proponents of this proposal usually do not address this issue. However, not accounting for the deferred tax liability relating to the investment property for the expected holding period implies the assumption that the investment property will be sold at least for its carrying amount. In deciding how much it is willing to pay for the investment property, however, a future purchaser would need to consider the fact that recovering the carrying amount of CU300 will cause Subsidiary B to pay income taxes of CU60.

Illustrative example—Proposal 2: Unit of account

A4. We want to illustrate the accounting resulting from Proposal 2–unit of account using the following example:

Fact pattern

The fact pattern is the same as in the scenario 'Accounting required by IAS 12 *Income Taxes*'. In addition, Subsidiary B has only (contingent) liabilities that are linked to (the ownership in) the investment property itself.

In the jurisdiction in which the investment property is located, investment property is, for tax and other reasons, usually bought and sold by transferring the shares in the entity housing the investment property.

Finally, Parent A expects to sell the shares in Subsidiary B at least for the carrying amount of the investment property of CU300. The fair value of the shares in Subsidiary B is CU290.

Technical analysis

Parent A recognises in its consolidated financial statements a single asset that is characterised as investment property at the fair value of the shares in Subsidiary B of CU290. This is because:

- *Subsidiary B houses only one asset and has only (contingent) liabilities that are linked to (ownership in) the asset inside itself, for example, a legal obligation of its owner to remove soil contamination;*
- *the asset inside is measured at fair value;*
- *the asset inside is usually bought and sold in that jurisdiction by buying and selling the shares in the entity housing it; and*
- *the parent expects to recover the carrying amount of the asset inside by selling or assumes this on the basis of a rebuttable assumption.*

In addition, Parent A recognises the deferred tax liability of CU19 related to the shares in Subsidiary B, because it is probable that the temporary difference relating to the investment in Subsidiary B will reverse in the foreseeable future (see paragraph 39 of IAS 12).

The deferred tax liability of CU9 results from applying the tax rate of 10 per cent to the taxable temporary difference of CU90 (CU290-CU200).

Illustrative example—Proposal 3: Measurement on a discounted basis

A5. We want to illustrate the accounting resulting from the Proposal 3–measurement on a discounted basis using the following example:

Fact pattern

The fact pattern is the same as in the scenario ‘Accounting required by IAS 12 *Income Taxes*’. In addition, the present value of the deferred tax liability related to the investment property is CU16. The difference between the measurement of the deferred tax liability according to IAS 12 of CU60 and its present value of CU16 relates to the fact that Parent A expects that Subsidiary B will recover the carrying amount of the investment property over the next 30 years.

Technical analysis

The technical analysis is the same as for scenario ‘Current IAS 12’ with the exception that Parent A does not recognise in its consolidated financial statements an undiscounted deferred tax liability of CU60 relating to the investment property held by Subsidiary B. Instead, it recognises a discounted deferred tax liability of CU16 relating to the investment property held by Subsidiary B.

In addition, Parent A recognises the undiscounted deferred tax liability of CU8 related to the shares in Subsidiary B, because it is probable that the temporary difference relating to the investment in Subsidiary B will reverse in the foreseeable future (see paragraph 39 of IAS 12).

The deferred tax liability of CU8 results from applying the tax rate of 10 per cent to the taxable temporary difference of CU84 (CU284 – CU200). The share of Parent A in the net assets of Subsidiary B, including deferred taxes, is CU284 (CU300 – CU16).

Appendix B—Proposed wording for tentative agenda decision

B1. The proposed wording for the tentative agenda decision is presented below.

IAS 12 Income Taxes—Recognition of deferred tax for a single asset in a corporate wrapper

The Interpretations Committee received a request to clarify the accounting for deferred tax in the consolidated financial statements of the parent, when the subsidiary has only one asset within it (the asset inside) and the parent expects to recover the carrying amount of the asset inside by selling the shares in the subsidiary (the shares).

The Interpretations Committee noted that:

- paragraph 11 of IAS 12 requires the entity to determine temporary differences in the consolidated financial statements by comparing the carrying amounts of assets and liabilities in the consolidated financial statements with the appropriate tax base. In the case of an asset or liability of a subsidiary which files separate tax returns this is the amount that will be taxable or deductible on the recovery (settlement) of the asset (liability) in the tax returns of the subsidiary.

- the requirement in paragraph 11 of IAS 12 is complemented by the requirement in paragraph 38 of IAS 12 to determine the temporary difference related to the shares of the parent in the subsidiary by comparing the parent's share of the net assets of the subsidiary, including the carrying amount of goodwill, with the tax base of the shares for purposes of the parent's tax returns.

The Interpretations Committee also noted that these paragraphs require a parent to recognise both the deferred tax related to the asset inside and the deferred tax related to the shares, if tax law considers the asset inside and the share to be two separate assets and if no specific exceptions in IAS 12 apply.

Furthermore, the Interpretations Committee noted that several concerns were raised in practice with respect to the current requirements in IAS 12. However,

analysing and assessing these concerns requires a broader project than the Interpretations Committee could do on behalf of the IASB

Consequently, the Interpretations Committee [decided] not to take the issue onto its agenda but rather to recommend to the IASB that it analyses and assesses these concerns in its research project on income taxes.