STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	**IAS 12 *Income Taxes***
Paper topic	Selection of applicable tax rate for measurement of deferred tax relating to investment in associate

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Introduction

1. The IFRS Interpretations Committee (the 'Interpretations Committee') received a request to clarify the requirement for the selection of the applicable tax rate for the measurement of deferred tax relating to an investment in an associate in a multi-tax rate jurisdiction.

Paper structure

2. This paper is organised as follows:

   (a) submission received;

   (b) extracts from the Standards;

   (c) summary of outreach conducted;

   (d) staff analysis of the issue;

   (e) assessment against the interpretations agenda criteria; and

   (f) staff recommendation.

Submission received

3. According to paragraph 51 of IAS 12 *Income Taxes*, 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 to recover or settle the carrying amount of its assets and liabilities. However, the submitter claims that no specific guidance is provided in relation to investments in associates that are accounted for using the equity method.

4. The submitter explains that, normally, the carrying amount of an investment in an associate could be recovered by (a) receiving of dividends (or other distribution of profit); (b) sale to a third party; or (c) receiving of residual assets upon liquidation of the associate. The investor normally considers all of these possible methods of recovery. One part of the capitalised profit may be received as dividends during the holding period. Another part may be recovered upon sale or liquidation. However, an investor usually does not have sufficient power to control the proportion of profit that will be distributed (as dividends) or retained (capitalised).

5. If local tax legislation prescribes the application of different tax rates for each manner of recovery (dividends, sale, liquidation), the submitter asked the question about what tax rate should be used to measure deferred tax on the investment in the associate. For example, tax legislation may prescribe the application of different tax rates: (a) 9 per cent for profit received if it is in the form of dividends and (b) 20 per cent for profit received in all other forms.

Extracts from the Standards

6. Paragraph 39 of IAS 12 states that an entity shall recognise a deferred tax liability for all temporary differences on associates unless the entity controls the timing of reversal and it is probable that the temporary difference will not reverse in the foreseeable future:

> 39 An entity shall recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, branches and associates,

> and interests in joint arrangements, except to the extent that both of the following conditions are satisfied:
>
> (a) the parent, investor, joint venturer or joint operator is able to control the timing of the reversal of the temporary difference; and
>
> (b) it is probable that the temporary difference will not reverse in the foreseeable future.

7. Paragraph 42 of IAS 12 specifically addresses the recognition of a deferred tax liability for an investment in an associate, as follows:

> 42 An investor in an associate does not control that entity and is usually not in a position to determine its dividend policy. Therefore, in the absence of an agreement requiring that the profits of the associate will not be distributed in the foreseeable future, an investor recognises a deferred tax liability arising from taxable temporary differences associated with its investment in the associate. In some cases, an investor may not be able to determine the amount of tax that would be payable if it recovers the cost of its investment in an associate, but can determine that it will equal or exceed a minimum amount. In such cases, the deferred tax liability is measured at this amount.

8. Paragraph 51A of IAS 12 prescribes that an entity measures deferred tax liabilities and deferred tax assets using the tax rate and the tax base that are consistent with the expected manner of recovery or settlement.

> 51A In some jurisdictions, the manner in which an entity recovers (settles) the carrying amount of an asset (liability) may affect either or both of:
>
> (a) the tax rate applicable when the entity recovers (settles) the carrying amount of the asset (liability); and
>
> (b) the tax base of the asset (liability).

> In such cases, an entity measures deferred tax liabilities and deferred tax assets using the tax rate and the tax base that are consistent with the expected manner of recovery or settlement.

Summary of outreach conducted

9. We have performed outreach with the securities regulators, International Forum of Accounting Standard Setters (IFASS) members, and global accounting firms. Specifically, we asked the following questions:

   Q1. Are you aware of examples of circumstances in which different tax rates would be applied for the recovery of investment in associates in the following cases?

   - receiving of dividends (or other distribution of profit);
   - sell to third party; or
   - receiving of residual assets upon liquidation of the associate.

   Q2. If yes to Q1, please would you:

   (a) inform us about how common this is in your jurisdiction;

   (b) describe the prevalent accounting approach/basis followed in your jurisdiction; and

   (c) provide us with examples that illustrate the practices that you observe and the reasons for the practice followed?

10. We received 20 responses from 3 securities regulators, 12 IFASS members and 5 global accounting firms.

11. By region, we received responses from the following 20 jurisdictions: Asia (4), Africa (1), Americas (3), Europe (4), Oceania (1), and International (7).

12. More than half of the respondents responded that they were aware of the issue. Other respondents stated that they were not aware of the issue because different tax rates would not be applied for the recovery of investments in associates.

13. Most of those who were aware of the issue responded that they were not aware of diversity in practice. Many respondents stated that the tax rate applicable to receiving dividends is used to calculate the deferred tax liability, unless there is a plan to sell or liquidate the investment. Some respondents stated that the tax rate applicable to sell or liquidate the investment is used to calculate the deferred tax liability, unless there is evidence that the investee will pay dividends. Some respondents commented that they thought an entity would bifurcate their investment into the portion expected to be recovered by way of dividend and sales/liquidation, and use the applicable tax rates to each component. .

Staff analysis of the issue

14. We note that a deferred tax liability should be recognised for all taxable temporary differences, in accordance with paragraph 39 and 42 of IAS 12.

15. We also note that an entity measures deferred tax liabilities and deferred tax assets using the tax rate and the tax base that are consistent with the expected manner of recovery or settlement, in accordance with paragraph 51A of IAS 12.

16. We noted that the differences in the responses on the outreach described in the paragraph 13 appear to reflect differences in the applicable facts and circumstances. Accordingly, those providing the feedback report that they are not aware of diversity in practice. We think this reflects the application of the principle in paragraph 51A of IAS 12 to different facts and circumstances.

17. We agree that, if one part of the capitalised profit is expected to be received as dividends, and another part is expected to be recovered upon sale or liquidation—eg the investor has a plan to sell the investment three years later and expects to receive dividends until it sells the investment—different tax rates would be applied to each part of capitalised profits, to be consistent with the expected manner of recovery.

18. On the basis of this analysis, we consider that the existing Standard provides sufficient guidance.

Assessment against the interpretations agenda criteria

Agenda criteria	
We should address issues (5.16):	
that have widespread effect and have, or are expected to have, a material effect on those affected.	**No.** On the basis of our analysis of the outreach results received, we consider that this issue is widespread but that diversity in practice does not exist.
whereby financial reporting would be improved through the elimination, or reduction, of diverse reporting methods.	**Not applicable.** We think that the existing paragraph 51A of IAS 12 provides sufficient guidance. We do not think diversity in practice exists.
that can be resolved efficiently within the confines of existing Standards and the *Conceptual Framework for Financial Reporting*.	**Not applicable.** We think that the existing paragraph 51A of IAS 12 provides sufficient guidance. We do not think diversity in practice exists.
In addition:	
Is the issue sufficiently narrow in scope that the Interpretations Committee can address this issue in an efficient manner, but not so narrow that it is not cost-effective for the Interpretations Committee to undertake the due process that would be required when making changes to IFRS (5.17)?	**Not applicable.** We think that the existing paragraph 51A of IAS 12 provides sufficient guidance. We do not think diversity in practice exists.
Will the solution developed by the Interpretations Committee be effective for a reasonable time period (5.21)? (The Interpretations Committee will not add an item to its agenda if the issue is being addressed in a forthcoming Standard and/or if a short-term improvement is not justified).	**Yes.** The issue does not relate to a current or planned IASB project.

Staff recommendation

19. We recommend that the Interpretations Committee should not take this issue onto its agenda, because we have no evidence of diversity in practice. We also note that paragraph 51A of IAS 12 provides sufficient guidance. This is because it requires an entity measures deferred tax liabilities and deferred tax assets using the tax rate and the tax base that are consistent with the expected manner of recovery or settlement—ie sale/liquidation or dividends.

Questions for the Interpretations Committee

1. Does the Interpretations Committee agree that an entity should select a tax rate for measurement of deferred tax relating to investment in associate to be consistent with the expected manner of recovery or settlement?
2. Does the Interpretations Committee agree with the staff's recommendation that the Interpretation Committee should not take this issue onto its agenda, because there is no diversity in practice?
3. Does the Interpretations Committee have any comments on the proposed wording in Appendix A for the tentative agenda decision?

Appendix A—Proposed wording for tentative agenda decision

A1. The proposed wording for the tentative agenda decision is presented below.

IAS 12 *Income Taxes*—Selection of the applicable tax rate for measurement of deferred tax relating to investment in an associate

The IFRS Interpretations Committee (the 'Interpretations Committee') received a request to clarify the selection of the applicable tax rate for the measurement of deferred tax relating to an investment in an associate in a multi-tax rate jurisdiction. The submitter has asked how the tax rate should be selected when local tax legislation prescribes different tax rates for different manners of recovery (dividends, sale, liquidation). The submitter described a situation in which the carrying amount of an investment in an associate could be recovered by (a) receiving dividends (or other distribution of profit); (b) sale to a third party; or (c) receiving of residual assets upon liquidation of the associate. The submitter states that an investor normally considers all of these variants of recovery. One part of the capitalised profit will be received as dividends during the holding period, and another part will be recovered upon sale or liquidation.

The Interpretations Committee noted that paragraph 51A of IAS 12 *Income Taxes* states that an entity measures deferred tax liabilities and deferred tax assets using the tax rate and the tax base that are consistent with the expected manner of recovery or settlement. Accordingly, the tax rate should reflect the expected manner of recovery or settlement. If one part of the capitalised profit is expected to be received as dividends, and another part is expected to be recovered upon sale or liquidation—eg an investor has a plan to sell the investment later and expects to receive dividends until the sale of the investment, different tax rates would be applied to the parts of capitalised profits, to be consistent with the expected manner of recovery.

The Interpretations Committee observed that it has no evidence of diversity in practice exists and IAS 12 contains sufficient guidance, accordingly, neither an Interpretation nor an amendment to a Standard was necessary. Consequently, the Interpretations Committee [decided] not to add the issue to its agenda.

Appendix B—Original agenda request

B1. We received the following submission. All information has been copied without modification, except for details that would identify the submitter of the request.

Measurement of deferred tax liability or asset that arises from investment in associate that is accounted for using equity method in accordance with IAS 28

Background

According to the paragraph 51 of IAS 12, 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 to recover or settle the carrying amount of its assets and liabilities.

According to the paragraph 51A of IAS 12, in some jurisdictions, the manner in which an entity recovers (settles) the carrying amount of an asset (liability) may affect either or both of: (a) the tax rate applicable when the entity recovers (settles) the carrying amount of the asset (liability); and (b) the tax base of the asset (liability). In such cases, an entity measures deferred tax liabilities and deferred tax assets using the tax rate and the tax base that are consistent with the expected manner of recovery or settlement.

The paragraphs 51A-51D of IAS 12 also provide corresponding examples and guidance in relation to property, plant and equipment, non-depreciable asset measured using the revaluation model, and investment property.

But no specific guidance is provided in relation to the investments in associates that accounted for using the equity method.

The paragraph 38 of IAS 12 gives only the statement and reasons when the carrying amount of investment in associates becomes different from the tax base and temporary differences arise.

Issue

Nevertheless, the measurement of deferred tax liability or asset that arises from investment in associate that is accounted for using equity method could be even more difficult and could create unnecessary divergence in practice.

Normally the carrying amount of an investment in associate could be recovered by (a) receiving of dividends (or other distribution of profit), (b) sell to third party, (c) receiving of residual assets upon liquidation of the associate. And normally the investor considers all of these variants of recovery. One part of capitalized profit will be received as dividends during the holding period. Another part will be recovered upon sell or liquidation. At the same such investor usually does not have enough power to control the proportion of profit that will be distributed (as dividends) or retained (capitalized).

If local tax legislation prescribes application of different tax rates for different manners of recovery (dividends, sell, liquidation), what tax rate should be used?

Example

A tax legislation prescribes application of different tax rates of profit tax: (a) **9%** for profit received if form of dividends and (b) **20%** for profit received in all other forms (with certain exception that are not relevant to this question).

As of the reporting date (say 31.12.2013) an investor accounts its share in associate using the equity method to the carrying amount of 1 500 CU (that includes cost – 500 CU and share in undistributed profit – 1 000 CU). The tax base of the investment is equal to its cost (500 CU).

The investor expects to receive dividends from the associate during an indefinite holding period. The investor also considers this investment as available for sale (it could be sold in some future periods; there is no plan to sell it immediately).

What tax rate (9% or 20%) should be used in order to calculate the deferred tax liability related to this investment?

Inside/outside perspective

To avoid misunderstanding we should note that the above-mentioned issue does not relate to discussion of inside/outside inside temporary differences held in context of the Project of Annual Improvements - 2011-2013 cycle.

The above-mentioned issue considers the measurement of deferred tax assets or liabilities only from the investor’s point of view (only “outside” perspective).