European Securities and Markets Authority

ESMA REGULAR USE

The Chair

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

Agenda Item Request: Tax effects from interest payments on equity instruments

Dear Mr. Upton,

The European Securities and Markets Authority (ESMA) is an independent EU Authority that contributes to enhancing the protection of investors and promoting stable and well-functioning financial markets in the European Union (EU). ESMA achieves this aim by building a single rule book for EU financial markets and ensuring its consistent application across the EU. ESMA contributes to the regulation of financial services firms with a pan-European reach, either through direct supervision or through the active co-ordination of national supervisory activity.

As a result of the review of financial statements carried out by national competent authorities and ESMA's co-ordination activities, we have identified an issue on the application of IAS 12 *Income Taxes* related to presentation of tax effects from interest payments on equity instruments.

A detailed description of the case is set out in the appendix to this letter.

We would be happy to further discuss this issue with you.

Yours sincerely,

Steven Maijoor

APPENDIX – DETAILED DESCRIPTION OF THE ISSUE

1. As part of their monitoring and supervisory activities, ESMA and national enforcers have identified divergent application of IAS 12 requirements regarding the tax effects from interest payments on equity instruments. Specifically, divergence is linked to the question whether the tax reductions triggered by the tax-deductible interest payments and by any tax-deductible costs of issuing these equity instruments should be accounted for in equity or in the statement of comprehensive income. The most common example of such equity instruments is issuance of perpetual bonds, as presented in this submission.

Description of the issue

2. Issued perpetual bonds, classified as equity according to IAS 32 *Financial Instruments: Presentation*, provide for annual interest payments at the discretion of the issuer which are recognised as an equity distribution in the IFRS financial statements. According to applicable national tax laws in many jurisdictions, perpetual bonds are classified as a liability for tax purposes and give rise to tax-deductible expenses for tax purposes.

View 1 – accounting for the tax effect in profit or loss

3. Proponents of view 1 believe that the tax reductions triggered by the tax-deductible interest payments and by any costs of issuing these perpetual bonds should be recognised in profit or loss.
4. They refer to paragraph 52A of IAS 12 which states that '*… in some jurisdictions, income taxes are payable at a higher or lower rate if part or all of the net profit or retained earnings is paid out as a dividend to shareholders of the entity. In some other jurisdictions, income taxes may be refundable or payable if part or all of the net profit or retained earnings is paid out as a dividend to shareholders of the entity*'. They believe that the tax deduction for the distribution is equivalent to a lower rate of income tax being applied to earnings distributed than that applied to equity.
5. For the circumstances described in paragraph 52A, paragraph 52B of IAS 12 states that *'… [t]he income tax consequences of dividends are more directly linked to past transactions or events than to distributions to owners. Therefore, the income tax consequences of dividends are recognised in profit or loss for the period as required by paragraph 58 except to the extent that the income tax consequences of dividends arise from the circumstances described in paragraph 58 (a) and (b).'*
6. Consequently, proponents of view 1 claim that the tax reduction on the distribution to the holders of perpetual bonds and on the costs of issuing is a refund of taxes on previous profits and as such is less related to the payments on the perpetual bonds. Therefore, it should be accounted for in profit or loss.[1]

[1] During the process of the Annual Improvements to IFRSs, 2009–2011 Cycle, an inconsistency was highlighted by many comment letters. Many respondents perceived an inconsistency between the guidance in IAS 12 on the income tax

View 2 – accounting for the tax effect in equity

7. Proponents of view 2 believe that the tax reduction triggered by the tax-deductible payments to the holders of the perpetual bonds and by tax-deductible costs of issuing the bonds should be recognised directly in equity.

8. According to paragraph 57 of IAS 12 '*accounting for the current and deferred tax effects of a transaction or other event is consistent with the accounting for the transaction or event itself*'. Furthermore, according to paragraph 58 of IAS 12, '*current and deferred tax shall be … included in profit or loss for the period, except to the extent that the tax arises from:*

> *(a) transaction or event which is recognised, in the same or a different period outside profit or loss, either in other comprehensive income or directly in equity (see paragraphs 61A to 65); …*'

9. They also point out that the general principle included in paragraph 57 of IAS 12 is exemplified in paragraphs 52A and 52B of IAS 12 when different tax rates are applied to distributed and undistributed profits, a situation which has similarities with the case at hand. However, IAS 12 does not deal with the situation where two different types of instruments accounted for as equity (e.g. perpetual bonds and common shares) are considered differently (i.e. as one liability instrument and one equity instrument) for tax purposes.

10. When there are neither two different tax rates for distributed and undistributed profits nor tax refunds for the distribution of profits, the specific guidance for the case underlying paragraphs 52A and 52B of IAS 12 is not applicable.

11. Consequently, for proponents of this view, paragraphs 52A and 52B of IAS 12 are not applicable, but the nature of the payments made determines whether the tax effects should be reflected within equity or within profit or loss. Therefore, the tax effect should be reflected in equity since in nature interest payments on perpetual bonds have the characteristics of distributions to owners. Specifically, these payments are not linked to past transactions or events and can be made regardless of whether there is an available profit in the current period or there had been profits in prior periods. Moreover, contrary to the dividend payments mentioned in paragraph 52B of IAS 12, holders of the related equity instruments are not required to be shareholders in addition to being bearers of these financial instruments.

Request

12. In order to achieve consistent application of IFRS, ESMA believes that clarification should be provided on whether the tax reductions triggered by the tax-deductible interest payments on and by any costs of issuing of equity instruments should be accounted for in equity or profit and loss. In this regard, divergent practice has been identified recently

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consequences on dividends in paragraph 52B and the guidance in paragraphs 58. See Staff Paper 10E on the IFRS IC Meeting, January 2012, Comment Letter Analysis, http://www.ifrs.org/Meetings/Pages/IFRS-Interpretations-January-2012.aspx, p. 4.

in several European jurisdictions, and reported to ESMA. Furthermore ESMA noted that there are different views in the accounting literature. Accordingly, ESMA suggests that the IFRS Interpretations Committee clarifies the IFRS requirements in this respect.