IFRS

STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	**IAS 12 Income Taxes**
Paper topic	Accounting for income tax consequences of interest payments on, and issuing costs of, financial instruments that are classified as equity

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Introduction

1. The IFRS Interpretations Committee ('the Interpretations Committee') received a request to clarify an issue relating to application of the requirements in IAS 12 *Income Taxes*. More specifically, the issue relates to the presentation of income tax consequences of interest payments on, and issuing costs of, financial instruments that are classified as equity (ie recognition of the income tax consequences directly in equity or in profit or loss).

2. The objective of this agenda paper is to provide the Interpretations Committee with a summary of the issue, along with the staff analysis and recommendation.

3. The submission is reproduced in full in Appendix B of this agenda paper.

4. This paper provides:

   (a) a summary of the issue;

   (b) staff analysis;

   (c) summary of the outreach result;

   (d) agenda criteria assessment;

   (e) staff recommendation;

(f) Appendix A—Proposed wording for tentative agenda decision; and

(g) Appendix B—Submission.

5. The key points arising in this paper are:

(a) Presentation of income tax consequences should be determined on the basis of the presentation of the transactions and events that give rise to those income tax consequences. With respect to income tax consequences arising from distribution on financial instruments that are classified as equity, an entity has to determine whether the income tax consequences are linked to past transactions and events or to the distributions.

(b) Income tax consequences arising from costs of issuing financial instruments that are classified as equity should be presented directly in equity, consistently with the presentation of the transaction that creates those income tax consequences.

(c) Income tax consequences arising from interest payments on financial instruments that are classified as equity are not linked to past transactions or events that were included in profit or loss in prior or present periods. This is because those income tax consequences are not associated with anything other than the interest payments themselves, which are recognised directly in equity. Consequently, such income tax consequences should be presented directly in equity, consistently with the presentation of the interest payments themselves.

Summary of the issue

6. The issue relates to the presentation of income tax consequences arising from (1) interest payments on financial instruments that are classified as equity; and (2) the costs of issuing such instruments.

7. The submitter described a scenario in which:

(a) an entity issues financial instruments, other than equity securities that provide dividends, that are classified as equity in accordance with IAS 32 *Financial Instruments: Presentation* (eg perpetual bonds that provide interest payments at the discretion of the entity); and

(b) interest payments on, and issuing costs for, these financial instruments are deductible for tax purposes.

8. Paragraph 35 of IAS 32 requires that distributions to holders of an equity instrument and transaction costs of equity transactions should be recognised directly in equity. Paragraph 35A of IAS 32 goes on to require that any income taxes arising from such distributions and transaction costs should be accounted for in accordance with IAS 12:

> 35 Interest, dividends, losses and gains relating to a financial instrument or a component that is a financial liability shall be recognised as income or expense in profit or loss. Distributions to holders of an equity instrument shall be recognised by the entity directly in equity. Transaction costs of an equity transaction shall be accounted for as a deduction from equity.
>
> 35A Income tax relating to distributions to holders of an equity instrument and to transaction costs of an equity transaction shall be accounted for in accordance with IAS 12 *Income Taxes*.

9. Paragraphs 52A and 52B of IAS 12 set out accounting requirements for tax consequences of dividends, which require those taxes to be recognised in profit or loss, except to the extent that the income tax consequences of dividends arise from transactions that are recognised outside profit or loss or from a business combination:

> 52A 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. In these circumstances, current and deferred tax assets and liabilities are measured at the tax rate applicable to undistributed profits.
>
> 52B In the circumstances described in paragraph 52A, the income tax consequences of dividends are recognised when a liability to pay the dividend is recognised. The 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).
>
> 58 Current and deferred tax shall be recognised as income or an expense and included in profit or loss for the period, except to the extent that the tax arises from:
>
> (a) 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–65); or
>
> (b) a business combination (other than the acquisition by an investment entity, as defined in IFRS 10 *Consolidated Financial Statements*, of a subsidiary that is required to be measured at fair value through profit or loss) (see paragraphs 66–68).

10. On the other hand, paragraph 61A of IAS 12 requires that income tax consequences arising from transactions that are recognised directly in equity should be recognised directly in equity:

> 61A Current tax and deferred tax shall be recognised outside profit or loss if the tax relates to

> items that are recognised, in the same or a different period, outside profit or loss. Therefore, current tax and deferred tax that relates to items that are recognised, in the same or a different period:
>
> (a) in other comprehensive income, shall be recognised in other comprehensive income (see paragraph 62).
>
> (b) directly in equity, shall be recognised directly in equity (see paragraph 62A).

11. In the light of these requirements, the submitter identified divergent application of IAS 12 requirements with respect to presentation of the income tax consequences arising from (1) interest payments on financial instruments that are classified as equity, and (2) the costs of issuing such instruments.

View A—Presentation of the income tax consequences in profit or loss

12. Proponents of this view believe that the tax deductions considered in this issue are equivalent to a lower rate of income tax being applied to distributed earnings (ie one of the circumstances included in paragraph 52A of IAS 12), and consequently the requirements in paragraph 52B apply to such tax consequences. They claim that the tax reductions are in effect a refund of taxes on previous profits and therefore they are less linked to the distributions to holders of the financial instruments.

13. Consequently, they believe that tax consequences, arising from (1) interest payments on financial instruments that are classified as equity, and (2) the costs of issuing such instruments should be recognised in profit or loss in accordance with paragraph 52B, except to the extent that the income tax consequences of these interest payments arise from the circumstances described in paragraphs 58(a) and (b).

View B—Presentation of the income tax consequences directly in equity

14. Proponents of this view claim that accounting for the income tax consequences should be consistent with the accounting for the transaction or event itself that gives rise to those income tax consequences, in accordance with paragraph 57 of IAS 12. They argue that because interest payments and issuing costs considered in this issue are both recognised directly in equity, any income tax consequences arising from those transactions should also be recognised directly in equity.

15. They would also point out that the principle in paragraphs 52A and 52B would not apply to the situation in the submission because there are neither two different tax rates for distributed and undistributed profits nor tax refunds for the interest payments.

16. In addition, they argue that interest payments are not necessarily linked to past transactions or events.

17. Consequently, they believe that tax consequences arising from (1) interest payments on financial instruments that are classified as equity, and (2) costs of issuing such instruments, should be recognised directly in equity.

Staff analysis

18. We think that it is important to first understand from the requirements in IAS 12 what determines the presentation of income tax consequences arising from distributions from, and transaction costs related to, equity securities. After identifying key principles in this respect, we can apply the principles to the income tax consequences considered in this agenda paper.

What determines the presentation of income tax consequences of distributions from and transaction costs related to equity securities?

19. Paragraph 57 of IAS 12 requires that accounting for the income tax consequences should be consistent with the accounting for the transaction or event itself that gives rise to those tax consequences, and paragraphs 58–68C provide guidance to implement this principle.

> Accounting for the current and deferred income tax consequences of a transaction or other event is consistent with the accounting for the transaction or event itself. Paragraphs 58 to 68C implement this principle.

20. Paragraphs 58 and 61A provide guidance from different directions, but what they require is consistent with each other and they require that:
    - (a) if income tax consequences arise from transactions or events that are recognised directly in equity, the tax consequences should also be recognised directly in equity; and similarly
    - (b) if income tax consequences arise from transactions or events that are recognised in profit or loss, the tax consequences should also be recognised in profit or loss.

21. We note that with respect to accounting for tax consequences of distributions from equity securities, IAS 12 provides detailed guidance in paragraphs 52A and 52B. Paragraph 52B requires that income tax consequences of dividends should be recognised in profit or loss as required by paragraph 58, except to the extent that the income tax consequences of dividends arise from transactions that are recognised outside profit or loss or from a business combination. Paragraph 52B explains that this is because '[t]he income tax consequences of dividends are more directly linked to past transactions or events than to distributions to owners.'

22. A dividend distribution from retained earnings is a distribution of the profits that are accumulated in retained earnings. To the extent that those profits were generated from transactions recognised in profit or loss, so we understand paragraph 52B to require that the tax on the distribution of those profits should also be recognised in profit or loss. However, if a payment on an equity instrument is not a 'distribution' of previously earned profits, then we think the approach in IAS 12 may lead to a different conclusion on presentation.

23. We are aware that in some jurisdictions entities are required to refer to their solvency instead of the level of retained earnings in determining whether and if

so how much they can distribute to owners. We think that when an entity pays a dividend in such a jurisdiction and if that dividend payment creates a tax consequence, the entity would still apply paragraphs 52B and 58(a) to assess whether all or part of the dividend relates to income arising from a transaction that was originally recognised in profit or loss. We think that such an entity would recognise the income tax consequences of a dividend in profit or loss to the extent that the distribution relates to income arising from a transaction that was originally recognised in profit or loss.

24. On the basis of the analysis, we understand that:

    (a) IAS 12 requires consistent presentation between income tax consequences and transactions or events that give rise to those income tax consequences; and

    (b) when distributions from equity shares are distributions of profit that was recognised in profit or loss, related income tax consequences should also be recognised in profit or loss, because in such a case the income tax consequences are more directly linked to past transactions or events than to distributions to owners.

25. Consequently, to apply the principles in IAS 12 to the income tax consequences considered in this agenda paper, we have to understand:

    (a) how interest payments on, and costs of issuing, equity securities are accounted for; and

    (b) with respect to the tax consequences of the interest payments, whether the income tax consequences arising from the interest payments are linked to past transactions or events, and if so, where those past transactions or events were recognised.

Accounting for interest payments on, and costs of issuing, financial instruments that are classified as equity

26. In accordance with paragraph 35 of IAS 32, distributions to holders of an equity instrument and transaction costs of an equity transaction should be recognised directly in equity.

27. Because the interest payments and the issuing costs considered in the submission relate to financial instruments that are classified as equity, these transactions should be recognised directly in equity, and not in profit or loss.

28. Because paragraph 57 of IAS 12 requires consistent presentation between income tax consequences and the transactions or events that give rise to those income tax consequences, we are of the view that any income tax consequences arising from the issuing costs should be recognised directly in equity.

29. However, because paragraph 52B provides specific guidance on presentation of income tax consequences of a distribution, we next analyse whether any income tax consequences arising from the interest payments on financial instruments that are classified as equity are linked to past transactions or events that were recognised in profit or loss.

Is there a linkage between income tax consequences of interest payments on equity securities and past transactions or events?

30. We are of the view that, unlike income tax consequences of dividends, income tax consequences of interest payments on equity securities are not necessarily linked to past transactions or events, because:

    (a) the interest payments that trigger tax deduction are not dependent on the existence of retained earnings; and

    (b) income tax consequences arising from these interest payments are not associated with anything other than the interest payments themselves.

Interest payments are not dependent on the existence of retained earnings

31. We think that the fact that dividends are generally distributed from retained earnings is important, because that is what makes the linkage between any tax consequences of dividends and past transactions and events that were recognised in profit or loss. Retained earnings are generally an accumulation of past transactions that were recognised in profit or loss. Because dividends are a distribution of these retained earnings, any income tax consequences of the dividends are related to these transactions. Consequently, the income tax consequences of dividends are recognised in profit or loss, consistently with the presentation of these associated transactions that were recognised in profit or loss.

32. We are aware that some hold a view that the requirement in paragraph 52B seems inconsistent with the general requirement in paragraph 57 because dividends that trigger any income tax consequences are recognised directly in equity. However, we are of the view that the observation in the previous paragraph is consistent with what paragraph 52B of IAS 12 seems to imply, which states that '[t]he income tax consequences of dividends are more directly linked to past transactions or events than to distributions to owners.' Consequently, despite the concern, we should analyse the issue included in this agenda paper on the basis of the requirement of paragraph 52B.

33. Having said that, with respect to interest payments on financial instruments that are considered in this agenda paper, the interest payments can be made irrespective of the existence of retained earnings. Consequently, we think that any income tax consequences arising from these interest payments are not necessarily linked to past transactions or events that were recognised in profit or loss.

34. We note that the interest payments considered in this agenda paper and the dividends described in 26 are similar in that they both can be paid, irrespective of the existence of retained earnings. However, as analysed in the following section, with respect to income tax consequences of the interest payments, we

think that they are not associated with anything other than the interest payments themselves, and therefore, the income tax consequences are not linked to past transactions or events.

Income tax consequences of interest payments are not associated with anything other than the interest payments themselves

35. We are of the view that income tax consequences arising from interest payments considered in this agenda paper are not associated with anything other than the interest payments themselves. This is because it is these interest payments themselves that create a deductible item for income tax purposes. We think that this also indicates that there is not a linkage between income tax consequences of the interest payments and past transactions that were recognised in profit or loss.

36. Unlike dividend payments that give rise to income tax consequences, the interest payments being analysed do not affect the tax rate, but instead they affect the taxable income. In the case of the income tax consequences of dividends, additional or refundable taxes are determined taking into account past transactions that were recognised in profit or loss, because the dividend payments affect a tax rate, and not the composition of the taxable income by which a tax rate is multiplied.

37. However, in the case of the income tax consequences arising from the interest payments, income tax consequences are determined without any consideration of other transactions that were recognised in the same or different accounting periods. This is because it is these interest payments themselves that become a deductible item in calculating taxable profit, and thus affect the amount of income taxes. In other words, income tax consequences arising from these interest payments cannot be associated with anything other than the interest payments themselves.

38. Consequently, we are of the view that income tax consequences arising from interest payments on financial instruments classified as equity are not linked to past transactions or events that were recognised in profit or loss.

Summary

39. On the basis of the analysis above, we are of the view that income tax consequences of interest payments on financial instruments that are classified as equity are not linked to past transactions or events that were included in profit or loss in prior or present periods, because:

    (a) the interest payments that trigger tax deductions can be made irrespective of the existence of retained earnings; and

    (b) income tax consequences arising from these interest payments are not associated with anything other than the interest payments themselves.

40. Consequently, we are of the view that income tax consequences arising from these interest payments should be presented directly in equity, consistently with the presentation of the interest payments themselves.

Summary of the outreach result

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

    (a) Question 1—Are these issues common or prevalent in your jurisdiction? If yes, please provide us with qualitative or quantitative information about how common they are.

    (b) Question 2—When faced with these issues, what is the prevalent practice applied in your jurisdiction, in what circumstance and why.

    (c) Question 3—Did you observe diversity in practice? If so, please explain how and why the accounting is diversified.

42. We received 16 responses from eight IFASS members, seven global accounting firms and securities regulator.

43. By region, responses were received from one securities regulator, seven global accounting firms and eight jurisdictions (three jurisdictions from Asia and

Oceania, three from Europe, and two from Americas). The views received represent informal opinions and do not reflect the formal views of those organisations.

Responses to Question 1

44. About half of the respondents said that the issue is common. Some of them said that the issue is common in a number of jurisdictions. A few of them commented that the issue is common particularly in France.

Responses to Question 2

45. About half of the respondents who commented that the issue is common said that the predominant accounting that they observed was presenting income tax consequences that are considered in the submission in equity.

46. Other respondents who said that the issue is common were either silent on the predominant accounting approach or said that they had not identified a predominant accounting approach for the issue. However, one of them expressed a preference for presentation of income tax consequences in question in equity on the basis of the general principle in paragraphs 58(a) and 61 of IAS 12. At the same time, this respondent said that it would be difficult to rule out the alternative view (presentation in profit or loss) because the wording of paragraph 52B of IAS 12 seems to support presentation in profit or loss, as long as the payment is considered to be a dividend.

Responses to Question 3

47. About one third of the respondents said that there is at least some diversity in practice. Some of them commented that because the guidance in not clear with this issue, some form of clarification would be helpful.

Agenda criteria assessment

Agenda criteria	
We should address issues (see paragraph 5.16 of the *IFRS Foundation Due Process Handbook*):	
that have widespread effect and have, or are expected to have, a material effect on those affected.	**Yes,** according to the feedback on the outreach, the issue is common in a number of jurisdictions.
in which financial reporting would be improved through the elimination, or reduction, of diverse reporting methods.	**No,** we think that even though there is diversity in practice to a certain degree, we think that there is sufficient guidance in existing Standards.
that can be resolved efficiently within the confines of existing IFRS and the *Conceptual Framework for Financial Reporting*.	N/A
In addition:	
Is the issue sufficiently narrow in scope that the Interpretations Committee can address it in an efficient manner, but not so narrow that it is not cost-effective for it to undertake the due process that would be required when making changes to IFRS (see paragraph 5.17 of the *IFRS Foundation Due Process Handbook*)?	N/A
Will the solution developed by the Interpretations Committee be effective for a reasonable time period (see paragraph 5.21 of the *IFRS Foundation Due Process Handbook*)? (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).	N/A

Summary and staff recommendation

48. A summary of our analysis is that:

    (a) Presentation of income tax consequences should be determined on the basis of the presentation of the transactions and events that created those tax consequences. With respect to income tax consequences arising from distribution on financial instruments that are classified as equity, an entity has to determine whether the tax consequences are linked to past transactions and events.

(b) Income tax consequences arising from costs of issuing financial instruments that are classified as equity should be presented directly in equity, consistently with the presentation of the transactions that create those income tax consequences.

(c) Income tax consequences arising from interest payments on financial instruments that are classified as equity are not linked to past transactions or events that were included in profit or loss in prior or present periods. Consequently, such income tax consequences should be presented directly in equity.

49. We think that our conclusion above can be drawn from the principles in IAS 12. Consequently, we recommend that the Interpretations Committee should not take this issue onto its agenda. The proposed wording for the tentative agenda decision is set out in Appendix A of this paper.

Questions for the Interpretations Committee
1. Does the Interpretations Committee agree with the staff's recommendation that it should not add this issue to its agenda? 2. If the answer to Question 1 is 'Yes', does the Interpretations Committee agree with the wording of the tentative agenda decision in Appendix A of this paper?

Appendix A—Proposed wording for the tentative agenda decision

A1. We propose the following wording for the tentative agenda decision.

IAS 12 *Income Taxes*—Accounting for income tax consequences of interest payments on, and issuing costs of, financial instruments that are classified as equity

The Interpretations Committee received a request to clarify an issue relating to application of the requirements in IAS 12 *Income Taxes*. More specifically, the issue relates to accounting for tax consequences of interest payments on, and issuing costs of, financial instruments that are classified as equity, and whether they should be recognised in profit or loss, or directly in equity.

The Interpretations Committee noted that:

(a) Paragraph 35 of IAS 32 *Financial Instruments: Presentation* requires that distributions to holders of an equity instrument and transaction costs of equity transactions should be recognised directly in equity. Consequently, the interest payments on, and the costs of issuing, financial instruments themselves that are considered in the submission are recognised directly in equity.

(b) Paragraph 57 of IAS 12 requires that presentation of income tax consequences should be consistent with the presentation of the transactions and events themselves that give rise to those income tax consequences.

(c) Paragraph 52B of IAS 12 provides more guidance on the presentation of the income tax consequences of dividends, which requires those income tax consequences to be recognised in profit or loss, except to the extent that they arise from transactions that are recognised outside profit or loss or from a business combination.

The Interpretations Committee noted that the costs of issuing financial instruments that are classified as equity would be recognised directly in equity in accordance with paragraph 35 of IAS 32. Consequently, the Interpretations Committee noted that any income tax consequences arising from such costs should be recognised directly in equity, consistently with the presentation of those costs.

With respect to income tax consequences of interest payments on financial

instruments that are classified as equity, the Interpretations Committee noted that it is important to understand whether those income tax consequences are linked to past transactions or events that were recognised in profit or loss. This is because, in accordance with paragraph 52B of IAS 12, the Interpretations Committee observed that the rationale for the accounting requirement in (c) above is because income tax consequences of dividends are more directly linked to past transactions or events than to distributions to owners.

The Interpretations Committee observed that income tax consequences arising from interest payments on financial instruments that are classified as equity would not be linked to past transactions or events that were recognised in profit or loss, because:

(a) these interest payments that trigger a tax deduction could be made, irrespective of the existence of retained earnings; and
(b) income tax consequences arising from these interest payments cannot be associated with anything other than the interest payments themselves, because it is these interest payments that create a tax deduction

Consequently, the Interpretations Committee noted that income tax consequences arising from interest payments on financial instruments that are classified as equity should be recognised directly in equity.

On the basis of this analysis, the Interpretations Committee concluded that, in the light of the existing requirements of IAS 12, sufficient guidance exists and that neither an Interpretation nor an amendment to a Standard was necessary. Consequently, the Interpretations Committee [decided] not to add this issue to its agenda.