
IASB[®] meeting

Date	April 2023
Project	Equity Method
Topic	Initial recognition of an investment in an associate—deferred taxes
Contacts	Filippo Poli (fpoli@ifrs.org) Mostafa Mouit (mmouit@ifrs.org)

This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board (IASB). This paper does not represent the views of the IASB or any individual IASB member. Any comments in the paper do not purport to set out what would be an acceptable or unacceptable application of IFRS[®] Accounting Standards. The IASB's technical decisions are made in public and are reported in the IASB[®] *Update*.

This Agenda Paper was originally posted for the March 2023 International Accounting Standards Board (IASB) meeting as Agenda Paper 13D but was not discussed. This Agenda Paper is Agenda Paper 13D for the March 2023 IASB with editorial amendments.

Purpose of this paper

1. The purpose of this paper is to discuss the application question: *Does an investor recognise a deferred tax asset (or liability) on the difference between its share of the fair value and the tax base of the associate's identifiable assets and liabilities?*¹

Staff recommendation

2. The staff recommend the IASB proposes: *An investor:*
 - (a) *recognises a deferred tax asset (or liability) on the difference between its share of the fair value and the tax base of the associate's identifiable assets and liabilities;*
and
 - (b) *presents that deferred tax asset (or liability) in the carrying amount of its investment in the associate.*

¹ To clarify, this application question is about the initial recognition of an investment in an associate, if the associate itself meets the definition of a business in accordance with IFRS 3 *Business Combinations*.

Structure of this paper

3. The paper is structured as follows:
 - (a) description of the application question (paragraphs 4–5 of this paper);
 - (b) background (paragraphs 6–11 of this paper);
 - (c) staff analysis (paragraphs 12–38 of this paper);
 - (d) question for the IASB; and
 - (e) Appendix—illustrative example.

Description of the application question

4. The equity method is applied from the date on which an investment becomes an associate or a joint venture. On obtaining significant influence, an investor applies paragraph 32 of IAS 28 *Investments in Associates and Joint Ventures* and recognises its share of the net fair value of the investee's identifiable assets and liabilities. This may require the investor to adjust the carrying amounts of investee's assets and liabilities—for the purpose of this paper these adjustments are referred to as fair value adjustments.
5. The application question is asking if the investor should recognise a deferred tax asset (or liability) on the fair value adjustments as part of the investment in the associate. For example: an investor purchases a 25% interest in an entity and obtains significant influence. The investor determines that the fair value of an item of equipment is CU400. The tax base and the carrying amount in the investee's financial statements is CU300. Does the investor recognise a deferred tax liability relating to its share of the fair value adjustment of CU100?

Background

6. IAS 12 *Income Taxes* applies to the recognition and measurement of deferred taxes. Paragraph 15 of IAS 12 requires recognition of a deferred tax liability for all taxable temporary differences, except to the extent that the deferred tax liability arises from:
 - (a) the initial recognition of goodwill; or

-
- (b) the initial recognition of an asset or liability in a transaction which:
- (i) is not a business combination; and
 - (ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).
7. Paragraph 24 of IAS 12 requires recognition of a deferred tax asset for all deductible temporary differences, to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised, unless the deferred tax asset arises from the initial recognition of an asset or liability in a transaction that:
- (a) is not a business combination;
 - (b) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss); and
 - (c) at the time of the transaction, does not give rise to equal taxable and deductible temporary differences.
8. To answer the application question in paragraph 1 of this paper, it should be considered whether the acquisition of the investment in an associate gives rise to deductible and temporary taxable differences; and whether the initial recognition exemption applies to the transaction.

Temporary differences

9. The application question in paragraph 1 of this paper concerns the fair value adjustments on the associate's net assets (inside temporary differences). IAS 12 includes requirements for temporary differences associated with investments in associates (outside temporary differences).
10. Paragraph 39 of IAS 12 requires recognition of a deferred tax liability for all taxable temporary differences associated with an investment in an associate, except to the extent that both of the following conditions are satisfied:
- (a) the investor 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.
11. Paragraph 44 of IAS 12 requires recognition of a deferred tax asset for all deductible temporary differences arising from an investment in an associate, to the extent that it is probable that, and only to the extent that, it is probable that:
- (a) the temporary difference will reverse in the foreseeable future; and
- (b) taxable profit will be available against which the temporary difference can be utilised.

Staff analysis

12. The staff identified three views on the application question in paragraph 1 of this paper:
- (a) View A—an investor should recognise deferred tax on the fair value adjustments in accordance with the requirements in IAS 12. The deferred tax is presented in the carrying amount of the investment in the associate.
- (b) View B—an investor should not recognise the deferred tax on the fair value adjustments because the fair value adjustments do not give rise to temporary differences as defined in paragraph 5 of IAS 12.
- (c) View C—an investor should not recognise the deferred tax on the fair value adjustments because it applies the initial recognition exemption in IAS 12.
13. The analysis and illustrative examples in this paper for simplicity ignore the effect of the outside temporary differences on the investment in the associate, see paragraph 9 of this paper.

Principles underlying IAS 28

14. At its June 2021 meeting, the IASB discussed the principles identified as underlying the requirements in IAS 28. The principles aim to provide the IASB with a toolkit that can help in analysing the application questions and develop answers to the questions.

15. In assessing the application question, the staff considered principles D and E. Principle D states:

Fair value at the date that significant influence or joint control is obtained provides the most relevant information and faithful representation of an associate's or joint venture's identifiable net assets.

16. Principle E states:

An investor recognises changes in an associate's or joint venture's net assets. An investor recognises the share of changes in net assets that it can currently access.

17. As the application question is about how to apply IAS 12 when recognising and measuring of an investment in an associate, the staff has also considered the objective of recognising deferred taxes.

Analysis of the different views

View A

18. In applying paragraph 32 of IAS 28, the investor applies procedures similar to those in IFRS 3 *Business Combinations* for the measurement of assets acquired and liabilities incurred in a business combination. Paragraph 18 of IFRS 3 requires the acquirer to measure those identifiable assets acquired and the liabilities assumed at their acquisition date fair value.
19. Paragraph BC198 of the Basis for Conclusion on IFRS 3 explains that fair value is the most relevant attribute for assets acquired and liabilities assumed in a business combination. Measurement at fair value also provides information that is more comparable and understandable than measurement at cost or on the basis of allocating the total cost of an acquisition.
20. Paragraph 19 of IAS 12 states that *temporary differences* arise when the tax base of the identifiable assets acquired and liabilities assumed are not affected by the business combination or are affected differently. For example, when the carrying amount of an asset is increased to fair value but the tax base of the asset remains at cost to the previous owner,

a *taxable temporary difference* arises which results in a *deferred tax liability*. The resulting deferred tax liability affects the measurement of the goodwill included in the carrying amount of the investment in the associate.

21. The acquisition date fair values affect the measurement of profit or loss in subsequent periods. For example, assume that in the example in paragraph 5 of this paper, the associate sells the equipment at its fair value immediately after the investor has obtained significant influence. The associate will report a disposal gain in profit and loss, but the investor has no gain to recognise because it measured its share of equipment at fair value on obtaining significant influence.
22. The objective of IAS 12 explains that the principal issue in accounting for income taxes is how to account for the current and future consequences of:
 - (a) the future recovery of assets and settlement of the carrying amount of assets (liabilities) that are recognised in an entity's statement of financial position; and
 - (b) transactions and other events of the current period that are recognised in an entity's financial statements.
23. IAS 12 requires an entity to recognise deferred tax, if it is probable that recovery of the carrying amount of an asset, or settlement of the carrying amount of a liability, will make future tax payments larger or smaller than they would be if such recovery or settlement were to have no tax consequence.
24. Continuing the example from paragraph 5 of this paper, if the investor recognises a deferred tax liability on the fair value adjustment, the investor would derecognise the deferred tax liability when the associate recognises the income tax. Consequently, the investor would have no gain and no tax expense. The appendix to this paper illustrates the outcome.
25. In the staff's view the recognition of a deferred tax liability provides a faithful representation of the transaction. Not recognising a deferred tax liability on the fair value adjustment would result in the investor recognising its share of the associate's a tax expense without a corresponding gain on the disposal of the equipment.

26. Consequently, in the staff's view the objective of recognising a deferred tax liability in paragraph 22 of this paper is met. The associate's disposal of the asset has a tax consequence for the investor because, although the investor does not directly pay tax, its cash inflows are affected as its share of the associate's profit has changed.
27. In the staff's view, the outcome of recognising deferred tax on the fair value adjustments is aligned with principles D and E, see paragraphs 15 and 16 of this paper. The recognition of the deferred taxes is a consequence of the measuring the investors share in the associate's identifiable assets and liabilities at fair value.

View B

28. Paragraph 5 of IAS 12 defines a temporary difference as the difference between the carrying amount of an asset or liability in the statement of financial position and its tax base.
29. Those that hold View B argue that the investor does not recognise the associate's individual assets and liabilities but a single investment in the associate. Consequently, there cannot be a temporary difference between the carrying amount and the tax base of an asset or liability as required by IAS 12.
30. While the investor's share in the associates identifiable assets and liabilities are not separately presented:
- (a) paragraph 32 of IAS 28 requires an investor to recognise its share of the net fair value of the associate's identifiable assets and liabilities; and
 - (b) paragraph 32 of IAS 28 also requires an investor to make appropriate adjustments to its share of the associate's profit or loss after acquisition for the fair values of the associate's assets and liabilities at acquisition date.
31. In the staff's view paragraph 32 of IAS 28 has the effect that the investor's share in an associate's identifiable assets and liabilities is part of carrying amount of the investment.
32. Furthermore, temporary differences exist for items that are not recognised on the entity's statement of financial position as assets or liabilities. Paragraph 9 of IAS 12 provides the example of research costs that are recognised as an expense but permitted as a deduction from

taxable profit only in later periods; the difference between the tax base of research costs and nil is a deductible temporary difference that results in a deferred tax asset. Therefore, in the staff's view there is no prerequisite for the recognition of deferred tax assets or liabilities that the item is recognised in the statement of financial position.

View C

33. Those that hold View C argue that deferred tax is not recognised because the initial recognition exemption in paragraphs 6–7 of this paper applies to the purchase of an investment in an associate, as the transaction:
- (a) is not a business combination; and
 - (b) at the date of the transaction affects neither accounting profit nor taxable profit.
34. Paragraph 22 of IAS 12 explains that the exemption is needed because, in its absence, an entity would have to recognise the deferred tax and adjust the carrying amount of the asset or liability by the same amount. Such adjustment would make the financial statements less transparent and open the possibility of a day-2 impairment.
35. The staff disagree that the initial recognition exemption applies, because an investor recognising deferred taxes on the fair value adjustments on its share of the associate's identifiable assets and liabilities would adjust the goodwill that forms part of the carrying amount of the investment.

Cost and complexity to produce the information

36. The staff considered the cost and complexity of requiring recognition of deferred taxes on the fair value adjustments. Recognising deferred taxes requires the following information:
- (a) the amount of the temporary difference;
 - (b) the applicable tax rate; and
 - (c) in relation to deferred tax assets, an assessment that the asset is recoverable.

37. The investor is already required to assess the amount in paragraph 36(a) of this paper. In relation to the rate in paragraph 36(b) of this paper, the assessment can become complex if the tax rate applicable depends on the manner in which the associate recovers the carrying amount of an asset.
38. In relation to the assessment in paragraph 36(c) of this paper, the staff note that a deferred tax asset would arise from a fair value adjustment to a liability. In the staff's view, these adjustments would rarely occur and in most cases the investor would make fair value adjustments to assets, which give rise to taxable temporary differences and deferred tax liabilities.

Question for the IASB

Question for the IASB

1. Does the IASB agree to propose an investor:
- (a) recognises a deferred tax asset (or liability) on the difference between its share of the fair value and the tax base of the associate's identifiable assets and liabilities; and
 - (b) presents that deferred tax asset (or liability) in the carrying amount of its investment in the associate?

Appendix – Illustrative example

- A1. An investor purchases a 25% interest in an associate on 31/12/20X1 for a consideration of 1,400CU and obtains significant influence. The associate meets the definition of a business in accordance with IFRS 3.
- A2. At the purchase date the carrying amount of the associate's net assets is CU3,800. The investor makes a fair value adjustment of CU600 to an item of property, plant and equipment (PPE) with a carrying amount of CU1,000 and a fair value of CU1,600. The investor's share of the fair value adjustment is CU150.
- A3. The tax rate for both the investor and the associate is 30%.
- A4. Two alternative scenarios are illustrated:
- (a) the associate sells the item of PPE immediately after the investor obtains significant influence (paragraphs A7-A11); and
 - (b) the associate continues using and depreciating the item of PPE (paragraphs A12-A17).

Measurement at initial recognition

- A5. Based on the staff recommendation in this paper that an investor recognises deferred tax on the fair value adjustments, the investor measures the investment at 31/12/20X1 at:

Fair value of share of the associate's net assets and liabilities	1,100
Deferred tax on fair value adjustment	(45)
Goodwill	<u>345</u>
Total	<u>1,400</u>

- A6. The deferred tax liability is calculated by multiplying the investor's share of the fair value adjustment by the tax rate: $600 * 25% * 30% = \text{CU}45$.

Scenario 1—Immediate sale of asset

A7. On 1/1/20X2, the associate sells the item of PPE for its fair value of CU1,600. The associate's pre-tax profit for 20X2 is CU1,800, income tax thereon is CU540 and the post-tax profit CU1,260.

A8. At 31/12/20X2, the investor would measure its share of the associate's profit or loss at:

Share of reported profit or loss	315
Reversal of fair value adjustment (see paragraph A2)	(150)
Reversal of deferred tax	<u>45</u>
Total	<u>210</u>

A9. The fair value adjustment is reversed because the asset has been sold to a third party.

A10. The investor's effective tax rate is:

Share of pre-tax profit or loss	(450-150) = 300
Tax expense (current and deferred)	(135-45) = 90
Effective tax rate	30%

A11. If the investor had not recognised the deferred tax on the fair value adjustment at the date of acquisition, the investor's tax expense would be CU135 with an effective tax rate of 45%.

Scenario 2—Continuing use of asset

A12. The associate depreciates the item of PPE at 20% with a depreciation charge of CU200 for the period. The profit or loss in the associate's financial statements for the year 20X2 is:

Profit and loss before depreciation	1,200
Depreciation of PPE	<u>(200)</u>
Pre-tax profit	1,000
Income tax	<u>(300)</u>
Net profit	<u>700</u>

A13. The investor's share of the reported pre-tax profit, income tax expense and net profit or loss are respectively CU250, CU75 and CU175.

A14. At 31/12/20X2, the investor recognises its share of the associate's profit or loss as:

Share of reported profit	175
Amortisation of fair value adjustment (depreciation adjustment)	(30)
Change in deferred tax liability	<u>9</u>
Total	<u>154</u>

A15. The amortisation of the fair value adjustment is calculated by multiplying the investor's share of the fair value adjustment by the depreciation rate: $600\text{CU} \times 25\% \times 20\% = \text{CU}30$.

A16. The investor's effective tax rate is:

Share of pre-tax profit or loss	$(250-30) = 220$
Tax expense (current and deferred)	$(75-9) = 66$
Effective tax rate	30%

A17. If the investor had not recognised the deferred tax liability on the fair value adjustment at the date of acquisition, the investor's tax expense would be CU75 and the effective tax rate 34%.