IFRS Accounting

Staff paper

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IASB® meeting

Date	**May 2024**
Project	**Rate-regulated Activities**
Topic	**Interaction with IAS 12 *Income Taxes***
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Objective

1. This paper sets out staff analysis and recommendations on the proposed guidance on the interaction between the proposals in the Exposure Draft *Regulatory Assets and Regulatory Liabilities* (Exposure Draft) and IAS 12 *Income Taxes*.

Staff recommendations

2. We recommend that the final Accounting Standard clarify that the income tax consequences of a regulatory asset or regulatory liability may give rise to a separate regulatory asset or regulatory liability.

Structure of the paper

3. This paper is structured as follows:

   (a) proposals in the Exposure Draft (paragraphs 5–6);

   (a) feedback (paragraphs 7–8); and

   (b) staff analysis (paragraphs 9–17).

4. This paper has three appendices:

   (a) Appendix A contains extracts from the Exposure Draft;

   (b) Appendix B summarises feedback on other matters raised by a few respondents and the staff response; and

   (c) Appendix C describes some methods used by regulators to compensate entities for income tax.

Proposals in the Exposure Draft

5. Paragraphs B42–B46 of the Exposure Draft discuss:

   (a) regulatory assets or regulatory liabilities that arise when the regulated rates do not fully reflect compensation (charge) for current tax expense (income) or for deferred tax liability (deferred tax asset)—(paragraphs B42–B43);

   (b) tax effects arising from the recognition of a regulatory asset or regulatory liability (paragraph B44); and

   (c) accounting for the tax effects in (b) when a regulator provides compensation (charge) for those effects in future regulated rates charged (paragraphs B45–B46).

6. For simplicity, the Illustrative Examples accompanying the Exposure Draft ignore income tax effects arising from the recognition of regulatory assets or regulatory liabilities. Examples 7A.11 and 7B.10 deal with regulatory assets or regulatory liabilities relating to income tax.

Feedback

7. Most respondents who commented on paragraphs B42–B46 of the Exposure Draft supported the proposed guidance.

8. A few respondents, mainly accounting firms and national standard-setters, suggested the IASB:

   (a) clarify whether the recognition of a regulatory asset or regulatory liability, including those associated with income taxes (paragraphs B42–B43 of the Exposure Draft), gives rise to the recognition of a deferred tax liability or deferred tax asset (paragraph B44 of the Exposure Draft);

   (b) clarify whether the income tax consequences of a regulatory asset or regulatory liability should be accounted for as a separate difference in timing; and

   (c) provide comprehensive examples to illustrate the application of the proposed guidance on the interaction with income taxes and the presentation of regulatory income or regulatory expense associated with income taxes.

Staff analysis

9. This section is structured as follows:

   (a) income tax consequences (paragraphs 10–1616); and

   (b) other matters (paragraph 17).

Income tax consequences: part of the measurement of the initial difference in timing or a different difference in timing?

10. A few respondents suggested the IASB clarify whether the income tax consequences of a regulatory asset or regulatory liability should form part of the measurement of that regulatory asset or regulatory liability (that is, one difference in timing) or whether these tax effects would give rise to separate regulatory assets or regulatory liabilities (that, is two differences in timing). We think these comments arise because different paragraphs of the proposed application guidance imply different outcomes:

(a) paragraphs B41(c), B44 and B45 imply that income taxes affect the measurement of regulatory assets and regulatory liabilities—that is, one difference in timing; and

(b) the example in paragraph B46 implies that there are two 'regulatory assets', one arising from a bonus and another arising from the entity's right to recover the tax effects related to the regulatory asset arising from the bonus—that is, two differences in timing.

11. Using the example in paragraph B46:

(a) an entity has a right to include a performance incentive (bonus) of CU60 in future regulated rates. This gives rise to a regulatory asset of CU60;

(b) the entity applies IAS 12 and determines that the regulatory asset of CU60 gives rise to a deferred tax liability of CU24—that is, the tax rate of 40% × CU60;

(c) the regulatory agreement allows the entity to recover all tax effects of the regulatory asset relating to the bonus. This means that the deferred tax liability in (b) gives rise to a regulatory asset. The example assumes the regulator compensates the entity for the income tax effects of the regulatory asset on a cash basis. The entity therefore applies paragraph 61 of the Exposure Draft to measure the regulatory asset on the same basis as the deferred tax liability and concludes the deferred tax liability of CU24 in (b) gives rise to a regulatory asset of CU24; and

(d) the entity then 'grosses up' the regulatory asset in (c) for additional deferred income taxes to reflect the fact that future increases in regulated rates charged, and therefore increases in revenues, will also affect future income taxes payable—which it also has the right to recover. For example, the regulatory asset of CU24 in (c) will give rise to an additional deferred tax liability of CU9.6, followed by CU3.8 and so on. This process would eventually increase the deferred tax liability and the regulatory asset related to the deferred tax liability by CU16 ((24 / (1 – 40%)) – 24), giving a total of CU40 for the deferred tax liability and the related regulatory asset.

12. The example in paragraph B46 includes a few simplifications. It assumes that the following all occur in the same reporting period:

(a) the entity recovers the regulatory asset related to the bonus (CU60);

(b) the total (grossed-up) income tax liability relating to (a) becomes current and the entity pays the related cash (CU40); and

(c) the entity recovers the regulatory asset related to the income tax effects in (b) (CU40).

13. In the example in paragraph 11, we think it would be appropriate to account for the regulatory asset arising from the bonus and the regulatory asset related to the deferred tax liability as separate differences in timing. This is because:

(a) regulators generally determine compensation for these two items separately—that is, compensation for performance incentives and compensation for income tax would generally be two different components when determining the allowed revenue for a period; and

(b) the methodologies for determining the compensation for these two components might differ—for example, the compensation for performance incentives is generally determined on an accrual basis with a time delay but the compensation for income tax, including the tax effects of any regulatory assets, might be determined on an accrual basis, a cash basis or using some other methodology (see Appendix C).[1]

14. We think an entity should consider whether its regulatory agreement compensates (charges) the entity for income tax, including the income tax effects arising from any regulatory assets or regulatory liabilities. The entity would then need to assess

[1] Appendix C describes some of the methods used by regulators to compensate entities for income tax.

whether that compensation (charge) gives rise to regulatory assets or regulatory liabilities and apply the appropriate measurement requirements.

15. A few respondents sought clarification of how regulatory assets and regulatory liabilities relating to income tax effects would be measured. The measurement of such regulatory assets and regulatory liabilities will depend upon how the regulator compensates (charges) the entity for these items. Feedback from outreach indicates that regulators use various methods for determining the amount and timing of compensation for income tax (see Appendix C). If, for example, the regulator compensates an entity for income tax only when the income tax liability has become current and the entity has paid the related cash, the entity would apply the measurement requirements in paragraph 61 of the Exposure Draft.[2] We do not think any further clarification of the measurement of such items is required. However, we think it would be helpful to clarify that the income tax consequences of a regulatory asset or regulatory liability may give rise to a separate regulatory asset or regulatory liability, rather than affecting the measurement of the initial regulatory asset or regulatory liability.

16. We recommend that the final Accounting Standard clarify that the income tax consequences of a regulatory asset or regulatory liability may give rise to a separate regulatory asset or regulatory liability.

Question 1 for the IASB
1. Does the IASB agree with the staff recommendation in paragraph 16?

Other matters

17. Appendix B summarises feedback on other matters raised by a few respondents and the staff response. We have suggested some drafting changes in relation to the

[2] Paragraphs 59–66 of the Exposure Draft deal with items affecting regulated rates only when the related cash is paid or received.

guidance on the tax base. Apart from that, we recommend taking no further action in relation to those matters.

Question 2 for the IASB
2. Does the IASB agree with the staff recommendation in paragraph 17?

Appendix A—Extracts from the Exposure Draft

A1. Paragraphs B41–B46 of the Exposure Draft explain the interaction between the model and IAS 12.

IAS 12 *Income Taxes*

B41 Paragraphs B42–B46 discuss:

(a) regulatory assets or regulatory liabilities that arise when the regulated rates do not yet fully reflect current tax expense (income), or when an entity has a deferred tax liability or a deferred tax asset (paragraphs B42–B43);

(b) deferred tax liabilities or deferred tax assets resulting from a regulatory asset or regulatory liability (paragraph B44); and

(c) how income taxes affect the measurement of regulatory assets and regulatory liabilities (paragraphs B45–B46).

B42 Tax expense is typically an allowable expense and tax income is typically chargeable income. In some cases, the regulated rate for a specified period does not include all of the current and deferred tax effects of transactions occurring during that period. For example, a regulatory agreement may determine regulated rates on a basis that:

(a) includes an estimate of the current tax expense (income), with any variance between estimated and actual amounts being added or deducted when determining regulated rates in future periods; or

(b) does not include deferred tax expense (income).

B43 Applying this [draft] Standard in such cases, an entity shall recognise a regulatory asset or a regulatory liability if some or all of the current and deferred tax effects of transactions in the current period will affect the regulated rates in future periods, or affected the regulated rates in earlier periods.

B44 The tax base of a regulatory asset or regulatory liability is typically nil. Consequently, the recognition of a regulatory asset or regulatory liability typically gives rise to the recognition of a deferred tax liability or deferred tax asset in accordance with IAS 12. However, before applying IAS 12, an entity shall assess how income taxes affect the measurement of regulatory assets and regulatory liabilities (paragraphs B45–B46).

B45 In estimating the future cash flows arising from a regulatory asset or a regulatory liability, an entity shall consider the effect of amounts it is entitled to add in determining future regulated rates as a result of paying any income taxes as it recovers the regulatory asset, or that it is obliged to deduct in determining future regulated rates as a result of recovering any income taxes as it fulfils the regulatory liability.

B46 For example, assume that an entity has a regulatory asset arising because a performance incentive (bonus) of CU60 has not yet been included in determining the regulated rates, that the tax rate is 40%, and that the regulatory agreement allows all tax cash flows to be included ultimately in determining the regulated rates. In the future periods in which the bonus is included in determining regulated rates, the entity will include an amount of CU100 which will provide the entity with a net tax cash inflow of CU60 after the income tax cash outflow of CU40 (CU100 × 40%). Consequently, in measuring its regulatory assets, the entity includes the cash flows arising from its right to recover both the bonus (CU60) and the income tax (CU40 (CU60 × 40 ÷ 60)) that will result from recovering that bonus. Thus, the measurement of the regulatory assets reflects pre-tax cash inflows of CU100. The resulting income tax cash outflows of CU40 (CU100 × 40%) are reflected in the measurement of the resulting deferred tax liability.

Appendix B—Other matters raised by a few respondents

<table>
<tr><th>Matter</th><th>Staff response</th></tr>
<tr><td>The tax base

A few respondents commented on paragraph B44 of the Exposure Draft (shown below, emphasis added). They:

(a) suggested the IASB clarify whether the recognition of a regulatory asset or regulatory liability, including those associated with income taxes (paragraphs B42–B43 of the Exposure Draft), gives rise to the recognition of a deferred tax liability or deferred tax asset;

(b) queried the statement that the tax base of a regulatory asset or regulatory liability is typically nil; and

(c) suggested that the IASB specify that the tax base of a regulatory asset or regulatory liability should be determined applying IAS 12.

B44 The tax base of a regulatory asset or regulatory liability is typically nil. Consequently, the recognition of a regulatory asset or regulatory liability typically gives rise to the recognition of a deferred tax liability or deferred tax asset in accordance with IAS 12. …</td><td>IAS 12 defines the tax base:

The tax base of an asset or liability is the amount attributed to that asset or liability for tax purposes.

An entity would determine the tax base of a regulatory asset or regulatory liability and the accounting for any temporary differences—that is, the differences between the carrying amount of the regulatory asset or regulatory liability and their tax bases—in accordance with IAS 12 and the relevant tax laws.

We think the final Accounting Standard should refer to the requirements in IAS 12, without commenting on the likely amount of the tax base. This would be consistent with other IFRS Accounting Standards such as IAS 29 Financial Reporting in Hyperinflationary Economies, which refers to differences between the carrying amounts and the tax bases of assets and liabilities without commenting on the likely amount of those differences (IAS 29, paragraph 32).</td></tr>
<tr><td>Examples

A few respondents requested more comprehensive examples to illustrate the application of the proposed guidance on the interaction with income taxes, including the presentation of regulatory income or regulatory expense associated with income taxes. For</td><td>The staff recommendation in paragraph 16 would clarify the example in paragraph B46 of the Exposure Draft.

We do not think examples illustrating the presentation of regulatory income or</td></tr>
</table>

Matter	Staff response
example, an accounting firm suggested that the example in paragraph B46 be converted into an illustrative example, and that tax assumptions be added to the existing illustrative examples.	regulatory expense relating to income taxes are required. The IASB has tentatively decided that an entity should present regulatory income or regulatory expense as a separate line item in the statement(s) of financial performance.[3] Regulatory income and regulatory expense associated with income taxes would be included in that separate line item—they are not treated any differently to other regulatory income and regulatory expense. We do not recommend adding tax assumptions to all illustrative examples—we think this could obscure the matters that the examples aim to illustrate.

[3] IASB Update December 2023.

Appendix C—Compensation for income tax

C1. This appendix describes some of the methods used by regulators to compensate entities for income tax in different jurisdictions. It is based on feedback from members of the Consultative Group for Rate Regulation and some preparers.

Method A—Cash basis

An entity is allowed to recover:

(a) estimated current income taxes in the period in which they are incurred. The regulatory agreement may or may not specify that differences between estimated and actual amounts are trued up in future regulated rates. If those differences are subsequently trued up, this method would give rise to differences in timing.

(b) deferred income taxes when the income tax liability (asset) becomes current and the entity pays the related tax (pays a reduced tax amount). This method would give rise to regulatory assets and regulatory liabilities which would be measured in accordance with paragraph 61 of the Exposure Draft.

Based on the feedback received, this method is common in North America, Asia-Oceania and Europe.

Method B—Compensation included in the regulatory return

The regulatory agreement compensates an entity for income tax by increasing the regulatory return on the regulatory capital base. The regulatory agreement grosses up the equity return component of the regulatory return using:

(a) a deemed tax rate that seeks to incentivise the entity to reduce actual tax costs below statutory rates. Differences between the deemed tax rate and the actual tax rate, or between the deemed tax expense or actual tax expense are not trued up. This method might not give rise to differences in timing—however this will depend on facts and circumstances.

(b) an estimated effective tax rate. Differences between the estimated and actual effective tax rate—that is calculated based on actual tax paid in respect of a reporting period—are trued up in future regulated rates. This method would give rise to regulatory assets and regulatory liabilities. The regulatory agreement compensates deferred income tax on a cash basis (see Method A).

Based on the feedback received, these methods are common in Africa and Asia-Oceania.

Method C—Compensation via a notional tax allowance

The regulatory agreement compensates the entity for income taxes via a notional tax allowance for a specific period. According to a respondent, that notional tax allowance is calculated based on the entity's regulatory tax asset base, which differs from the entity's tax asset base. That respondent was of the view this method would not give rise to differences in timing because the regulatory compensation for income tax is calculated using regulatory principles that differ significantly from those used for accounting purposes.

Based on the feedback received, this method is used in Asia-Oceania.