IFRS® Accounting

Staff paper

Agenda reference: 13D

IASB® meeting

Date	**March 2023**
Project	**Equity Method**
Topic	**Initial recognition of an investment in an associate–deferred taxes**
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Purpose of this paper

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

Staff recommendation

2. The staff recommend the IASB proposes: *An investor recognises deferred tax assets or liabilities on the differences between the fair value and the tax base of its share of the associate's identifiable assets and liabilities.*

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 to the IASB (paragraph 39 of this paper); 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 deferred tax assets or liabilities on the fair value adjustments. 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 400CU. The tax basis and the carrying amount in the investee's financial statements is 300CU. Does the investor recognise a deferred tax liability relating to its share of the fair value adjustment of 100CU?

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, we need to consider 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.

    (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 to the recognition and measurement 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 of 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 bases 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 goodwill.

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 for the 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 settles 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, the staff consider 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. The staff also consider 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 the net fair values of its share of the associate's net 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, the staff note that temporary differences exist for items that are not recognised 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, the staff does not agree it is a prerequisite for the recognition of deferred tax assets or liabilities that the liability or asset must have a carrying amount.

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 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. We think that 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 to the IASB

39. Based on the analysis in paragraphs 12 to 38, the staff support View A.

Question to the IASB
1. Does the IASB agree with the staff recommendation in paragraph 2 of this paper to propose an investor recognises deferred tax assets or liabilities on the differences between the fair value and the tax base of its share of the associate's identifiable assets and liabilities?

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.

A2. At the purchase date the carrying amount of the associate's net assets is 3,800CU. The investor makes a fair value adjustment of 600CU to an item of property, plant and equipment (PPE) with a carrying amount of 1,000CU and a fair value of 1,600CU. The investor's share of the fair value adjustment is 150CU.

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	345
Total	1,400

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%=45CU.

Scenario 1—Immediate sale of asset

A7. On 1/1/20X2, the associate sells the item of PPE for its fair value of 1,600CU. The associate's pre-tax profit for 20X2 is 1,800CU, income tax thereon is 540CU and the post-tax profit 1,260CU.

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	45
Total	210

A9. The fair value adjustment is reversed because the PPE 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 135CU 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 200CU 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	(200)
Pre-tax profit	1,000
Income tax	(300)
Net profit	700

A13. The investor's share of the reported pre-tax profit, income tax expense and net profit or loss are respectively 250CU, 75CU and 175CU.

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	9
Total	154

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: 600CU*25%*20%= 30CU.

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 75CU and the effective tax rate 34%.