Deferred Tax related to an Investment in a Subsidiary (IAS 12 *Income Taxes*)—June 2020

The Committee received a request about how an entity, in its consolidated financial statements, accounts for deferred tax related to its investment in a subsidiary. In the fact pattern described in the request:

a. undistributed profits of the subsidiary give rise to a taxable temporary difference associated with the entity's investment in the subsidiary.
b. the entity has determined that the conditions in paragraph 39 of IAS 12 for applying the exception from recognising a deferred tax liability related to its investment in the subsidiary are not satisfied because the entity expects the subsidiary to distribute its profits (which are available for distribution) in the foreseeable future.
c. the entity and subsidiary operate in a jurisdiction in which:
    i. profits are taxable only when distributed—that is, the income tax rate applicable to undistributed profits is nil (undistributed tax rate).
    ii. a 20% tax rate applies to profit distributions (distributed tax rate). However, profit distributions made by the entity are not taxable to the extent that the subsidiary has already been taxed on that profit—that is, profit distributions are taxed only once.

The request asked whether the entity recognises a deferred tax liability for the taxable temporary difference associated with its investment in the subsidiary.

Paragraph 39 of IAS 12 requires an entity to recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, except to the extent that (a) the parent 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.

In the fact pattern described in the request, there is a taxable temporary difference associated with the entity's investment in the subsidiary. The entity has also determined that the recognition exception in paragraph 39 of IAS 12 does not apply because it is probable that the temporary difference will reverse in the foreseeable future when the subsidiary distributes its undistributed profits. Accordingly, the Committee concluded that the entity recognises a deferred tax liability for that taxable temporary difference.

Paragraph 51 of IAS 12 requires an entity to reflect—in the measurement of deferred tax assets and deferred tax liabilities—'the tax consequences that would follow from the manner in which the entity expects, at the end of the reporting period, to recover or settle the carrying amount of its assets and liabilities'.

In the fact pattern described in the request, the entity expects to recover the carrying amount of its investment in the subsidiary through distributions of profits by the subsidiary, which would be taxed at the distributed tax rate. Accordingly, the Committee concluded that, in applying paragraph 51 of IAS 12, the entity uses the distributed tax rate to measure the deferred tax liability related to its investment in the subsidiary.

The Committee observed that, in the fact pattern described in the request, the entity does not apply paragraph 57A of IAS 12—that paragraph applies only in the context of dividends payable by the reporting entity. Further, paragraph 52A of IAS 12 does not apply to the measurement of a current or deferred tax asset or liability that itself reflects the tax consequences of a distribution of profits.

The Committee concluded that the principles and requirements in IAS 12 provide an adequate basis for an entity to account for deferred tax in the fact pattern described in the request. Consequently, the Committee decided not to add the matter to its standard-setting agenda.