Accounting for deferred tax in respect of undistributed profits in the subsidiaries in tax regimes where income tax is payable upon distribution rather than profit

The issue

In 2000, Estonia adopted new corporate income tax legislation, whereby the traditional **profit-based tax regime** was replaced by **distribution-based tax regime** that in brief works as follows:

- Corporate profits are not taxable as long as they remain undistributed – ie tax rate applicable to undistributed profits is 0.
- In case of dividend distribution, 20% tax rate applies (eg distributing 100 as gross dividends results in a tax expense of 20 and net dividend received by shareholders of 80) – ie tax rate applicable to distributed profits is 20%.
- In case of groups, any distributions are taxed only once. For example, when a subsidiary pays a dividend of 100 to its parent then 20% tax is payable and the parent receives a net dividend of 80. When parent pays this 80 further to its shareholders then no further tax is payable on it because it was taxed already at the subsidiary level (ie the ultimate owners receive net dividend of 80). Therefore, from economic point of view it does not matter whether the profit used for dividend payments arose in the parent or subsidiary as the amount of tax payable is the same in both cases (in practice, subsidiaries usually pay dividends to their parent at the same time when the parent pays dividends to its ultimate owners).

In recent years, several other countries (eg Latvia, Georgia and Macedonia) have adopted similar tax regimes and some more countries (eg Ukraine) are considering doing it.

Also in 2000, certain amendments were introduced into IAS 12 (paragraphs 12.52A and 52B) addressing tax jurisdictions like Estonia where tax is payable based on distribution rather than profit. According to IAS 12.52A, where *"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…, current and deferred tax assets and liabilities are measured at the tax rate applicable to undistributed profits."* Furthermore, IAS 12.52B (since 1 January 2019 moved to paragraph 57A)[1] clarified that *"in the circumstances described in paragraph 52A, the income tax consequences of dividends are recognized when a liability to pay the dividend is recognized."*

While those amendments to IAS 12 have made it clear that in the distribution-based tax regimes no deferred tax shall be recognised at the parent entity level until dividends are recognised, there is less clarity about the treatment of any profits arising at the subsidiary level as no similar amendments were made to the respective section in IAS 12 ("Investments in subsidiaries, branches and associates and interests in joint arrangements"; paragraphs 38-45). This section has been written in the context of "traditional" profit-based income tax and does not contain any special clauses for jurisdictions where tax is paid upon profit distribution rather than profit creation.

In the context of distribution-based tax regimes (where tax is payable upon distribution rather than profit), there appears to be potential inconsistency between paragraphs 52A/57A and 39-40. While paragraphs 52A/57A stipulate that no current or deferred tax liability shall be recognised until a liability to pay dividends is recognised, paragraphs 39-40

[1] Paragraph 52B was moved to paragraph 57A as part of the amendments to IAS 12 effective for periods beginning on or after 1.01.2019 (further referred to as 57A)

require that deferred tax shall be recognised for all taxable differences associated with investments in subsidiaries, unless it is probable that the profits will not be distributed in the foreseeable future. This inconsistency has caused different views and market practices in countries where taxation is based on distribution rather than profit:

- *View 1 – no deferred tax is recognised in respect of undistributed profits, regardless of whether it arose in the parent or subsidiary.*

  The proponents of that view believe that the principle set out in IAS 12.52A/57A should apply not only to the parent company of the Group but also to other entities in the group. Therefore, if a subsidiary operates in a distribution-based tax jurisdiction, no tax should be recognised in respect of profits generated in that subsidiary until dividends are declared. The proponents of that view argue that paragraphs IAS 12.52A/57A have been specifically designed for distribution-based tax regimes while paragraphs 39-40 (that seem to be inconsistent with that view) have been written in the context of profit-based tax regimes and do not address the specifics of the distribution-based tax regimes. While paragraphs 39-40 provide guidance on calculating the tax base in respect of subsidiaries, paragraphs 52A/57A stipulate that the tax rate applicable to undistributed profits (ie zero) has to be used in those circumstances, regardless of single entity, parent company or subsidiary. The proponents also believe that treating the profits arising in all group entities (ie the parent and subsidiaries) consistently provides more relevant information to the users of the financial statements.

- *View 2 – while no deferred tax is recognised in respect of undistributed profits in the parent, deferred tax shall be recognised in respect of undistributed profits in the subsidiaries*

  The proponents of that view believe that the principles set out in IAS 12.52A/57A apply to the accounting for tax consequences in respect of undistributed profits arising in the parent company only and not to the subsidiaries. Instead, income tax in respect of undistributed profits retained in the subsidiary shall be recognised in line with IAS 12.39-40. Even if that may appear inconsistent with paragraphs 52A/57A, the guidance in paragraphs 39-40 prevails, as this specifically addresses the accounting for taxable temporary differences associated with the investments in subsidiaries.

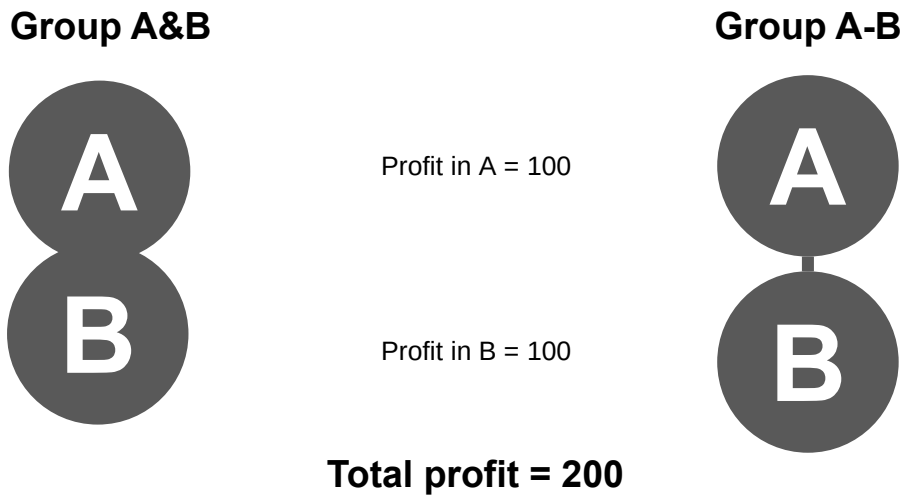
While the market practice in Estonia has been in line with View 1, the market practice in some other countries that have adopted distribution-based tax regimes more recently has been either mixed or based on View 2.

Both views are illustrated further in the example below.

Example

Background information

Groups A&B and A-B are identical groups, both consisting of two business units (A and B), with the only difference that in case of group A&B both business units are in **one legal entity**, while in group A-B they are in **two legal entities** (parent A and subsidiary B).



The consolidated balance sheets of both groups are identical and both groups earn profit of 200, out of which 100 is generated in business unit A and 100 in business unit B. Both groups operate in a jurisdiction where income tax is payable only when profit or retained earnings are paid out as dividends. Tax rate is 20% of the gross distribution.
Both groups declare and pay gross dividends of 200 on 31 March of the following year, resulting in both groups in an income tax payable of 40 and net dividends received by shareholders of 160.[2]

Accounting for Group A&B

IAS 12.52A/57A are clear that in distribution-based tax regimes current and deferred tax assets and liabilities are measured at the tax rate applicable to undistributed profits. Income tax consequences of any dividends are recognised when a liability to pay dividends is recognised. Thus there is a consistent view that in case of a single legal entity no income tax is recognised until 31 March of the following year when the dividends are declared and paid (when income tax expense of 40 is recognised).

Accounting for Group A-B

View 1 – no deferred tax is recognised in respect of undistributed profits, regardless of whether it arose in the parent or subsidiary

Proponents of that view believe that the principles set out in IAS 12.52A/57A should apply not only to the parent company of the Group but also to other entities in the group. Therefore, if subsidiary B operates in a jurisdiction where income tax is payable only when profit is distributed then no income tax should be recognised before that moment.

[2] In case of group A-B, the dividend payment occurs in two steps: firstly subsidiary B pays dividends to parent A and thereafter parent A pays dividends to its shareholders. Dividends are taxed only once, thus paying 200 gross dividends results in 40 tax expense and 160 net dividends received by the shareholder (ie exactly the same tax consequences as for group A&B).

Furthermore, the proponents of that view believe that the legal structure of the group shall not have any impact on the accounting treatment. Therefore, regardless of whether the group consists of one legal entity (A&B) or two legal entities (A-B), they should recognise income tax at the same time, if they are otherwise identical and subject to the same taxation regime. Under this view no tax expense would be recognised until dividend payments on 31 March of the following year.

View 2 - while no deferred tax is recognised in respect of undistributed profits in the parent, deferred tax shall be recognised in respect of undistributed profits in the subsidiaries

Proponents of that view believe that the principles set out in IAS 12.52A/57A apply to the parent company only but not to the subsidiary. Instead, income tax in respect of any undistributed profits in the subsidiary shall be recognised in line with IAS 12.39-40. As a result, group A-B would recognise no income tax in respect of profit arising in legal entity A but it would recognise income tax in respect of profit arising in legal entity B. Therefore, the timing of recognition of income tax expense in respect of profit arising in entity A would be different from that arising in entity B, although both profits are taxable at the same time (when they are distributed).

The following table summarises the financial impact of application of views 1 and 2 for the group A-B in comparison to the accounting for an identical group A&B that consists of one legal entity only:

	Group A&B	**Group A-B View 1**	**Group A-B View 2**
Profit in unit A	100	100	100
Tax recognised in respect of unit A	-	-	-
Profit in unit B	100	100	100
Tax recognised in respect of unit B	-	-	(20)
Total pre-tax profit	200	200	200
Total tax expense recognised for the year	**-**	**-**	**(20)**
Total after-tax profit for the year	**200**	**200**	**180**
Tax expense recognised when dividends are declared and paid	**(40)**	**(40)**	**(20)**

Other considerations – faithful representation, comparability and relevance to the users of the financial information

Application of View 1 results in a consistent approach in respect of accounting for tax consequences regardless of whether the group consists of one or more legal entities. Two identical groups A&B (consisting of one legal entity) and A-B (consisting of two legal entities) would both recognise the same amount of tax expense at the same time when dividends are declared, reflecting the fact that in economic terms they are subject to identical taxation rules. As at the year end the equity of both groups would be equal as one would expect in case of two groups with identical assets, liabilities and tax regimes.

Application of View 2 would result in a different deferred tax accounting depending on whether the group consists of one or more legal entities. In case of one legal entity (A&B) no deferred tax would be recognised at year end. In case of more legal entities (A-B), no tax is recognised in respect of profits arisen in the parent but deferred tax is recognised in respect of profits generated in subsidiaries. As a result, two otherwise identical consolidation groups may have different profit and equity, depending on whether they consist of one or more legal entities and/or whether more profit is generated at the parent or subsidiaries level. It appears to be misleading to the users of the financial statements that two otherwise identical groups operating in the same tax regime and being subject to

the same amounts of taxes payable could apply different deferred tax accounting and therefore show different profit and equity depending on their legal structure (although those differences in legal structure would not have any impact on actual amounts of taxes payable).

Questions to the Interpretations Committee

We have the following questions to the Interpretations Committee:

(1) In the context of the existing standards, does the Interpretations Committee support View 1 or View 2 as described above (or any other view)?

(2) In case the Interpretations Committee supports View 2, do you share the concerns regarding faithful representation, comparability and relevance as described above? Would the Interpretation Committee support amending IAS 12 in order to specifically address accounting for deferred tax for profits generated in the subsidiaries in tax regimes where income tax is payable upon distribution rather than profit (ie to extend the specific clauses set out in IAS 12.52A/57A also to subsidiary level).