Project: **Income Tax**

Topic: **Proposals to respond to comments on the exposure draft**

Introduction

1. The purpose of this paper is to present the staff proposals on how the Board should address the issues raised in comment letters on the exposure draft *Deferred Tax: Recovery of Underlying Assets* (the ED).

2. This paper contains:

   (a) the staff proposal to address the issues raised in comment letters (this section includes paragraph numbers that refer to paragraphs in the agenda paper 1A (Comment letter analysis));

   (b) a question to the Board;

   (c) next steps;

   (d) Appendix A – the issue of a single asset entity (also known as an entity wrapper); and

   (e) Appendix B - the staff proposal in March 2010 to solve the double counting of tax effects.

3. In the ED, the Board proposed;

   (a) an exception to the measurement principle in IAS 12 *Income Taxes*. That principle requires that the measurement of deferred tax liabilities and deferred tax assets should reflect the tax consequences that would follow from the manner in which the entity expects to recover or settle the carrying amount of its assets and liabilities. The exception would

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The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

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apply when specified underlying assets are remeasured, or revalued, to fair value.

(b) applying the exception when deferred tax liabilities or deferred tax assets arise from:

  (i) investment properties that are measured using the fair value model in IAS 40 *Investment Property*;

  (ii) property, plant and equipment or intangible assets measured using the revaluation model in IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets*; or

  (iii) investment property, property, plant and equipment or intangible assts initially measured at fair value in a business combination if the entity uses the fair value model or revaluation model when subsequently measuring the underlying assets.

(c) measuring deferred tax liabilities and deferred tax assets by applying a rebuttable presumption that the carrying amount of the underlying asset will be recovered entirely through sale when the exception applies;

(d) that this presumption would be rebutted only when an entity has clear evidence that it will consume the asset's economic benefits throughout its economic life;

(e) a clarification that this exception does not change the IAS 12 requirements to assess deferred tax assets for recoverability;

(f) a disclosure requirement when the presumption is rebutted; and

(g) full retrospective application of the amendment without any transitional provision.

4. The proposals in the ED were broadly supported by respondents from jurisdictions in which the current practice issue exists. On the other hand, many respondents from other jurisdictions, especially Europe, stated in their comment letters that they prefer maintaining the principles in IAS 12, rather than creating an exception. They also stated that, if the Board goes ahead with an exception, the scope should be limited to investment property.

5. As a result of the feedback received in the comment letters, the staff believe that there are three alternatives that the Board should consider when finalising the proposals. Those three alternatives are;:

    (a) an exception as originally proposed in the ED (Alternative A);

    (b) a narrow scope exception limited only to investment property measured using the fair value model in IAS 40 (Alternative B); or

    (c) application guidance on recovery of revalued property and investment properties carried at fair value (Alternative C).

    Changes from the ED under each alternative are summarised in Appendix C.

6. Of these alternatives, **the staff recommend Alternative B, the narrow scope exception because the staff think that:**

    (a) Alternative B will create a result similar to the entity's expectation relating to the recovery of investment properties carried at fair value with a minimum level of unintended consequences, if any;

    (b) Alternative A could produce benefits in a particular jurisdiction where there are practice issues involving property, plant and equipment exists, but those benefits are insufficient to outweigh additional burdens that alternative A would produce in other jurisdictions; and

    (c) application guidance in Alternative C does not solve the practice issue involving the difficulty and subjectivity of determining the expected manner of recovery.

7. Alternative B does not solve the practice issue in a particular jurisdiction involving property, plant and equipment. The staff think that the primary issue in that particular jurisdiction (New Zealand) is the issue of double counting tax effects (see Appendix B) rather than the difficulty and subjectivity of determining the expected manner of recovery. The Board should consider a second round of amendments to IAS 12 in due course if it wants to solve the double counting issue comprehensively.

The staff proposals to address issues raised in comment letters

(the paragraph numbers in this section refer to paragraphs in agenda paper 1A (Comment letter analysis))

8. Paragraphs 10 - 69 discuss the following seven issues raised by respondents and appendix C summarises how the staff propose to address each of those issues within the context of the three alternatives considered by the staff:

   (a) Issue 1: Form of the guidance

   (b) Issue 2: Measurement base

   (c) Issue 3: SIC-21 *Income Taxes – Recovery of Revalued Non-Depreciable Assets*

   (d) Issue 4: Assessment of deferred tax assets

   (e) Issue 5: Disclosure requirement

   (f) Issue 6: Full retrospective application

   (g) Issue 7: Timing of recovery by sale

9. Paragraphs 70 - 81 and appendices A and B summarise three other issues addressed in this paper:

   (a) An issue of a single asset entity (also known as an entity wrapper)

   (b) An issue of double counting tax effect

   (c) Land appreciation tax in People's Republic of China

Issue 1: The form of guidance

Alternative A (an exception as proposed in the ED)

10. Many respondents in specific jurisdictions such as Hong Kong, New Zealand, Canada and South Africa broadly supported the proposed exception (Para 7). These jurisdictions are jurisdictions in which this practice issue exists. Although respondents from other jurisdictions did not support the proposed exception, they are not facing this practice issue and they possibly did not understand the issue the Board was trying to resolve by this proposal. Therefore, supporters of

alternative A believe that the Board should go ahead with the exception as proposed in the ED.

11. The staff note that the Board's reason in the ED for creating an exception rather than providing extended guidance was that the exception would be simple and straight forward and would avoid unintended consequences by having a strictly defined scope. Many respondents suggest application guidance rather than an exception (Para 13). However, the staff think that there is still merit in a simple and straight forward exception as a practical solution to achieve a result that is similar to the entity's expectation when the IAS 12 measurement principle is difficult and subjective to apply.

12. Those respondents from other jurisdictions expressed various concerns, including:

    (a) the proposals in the ED would impose an additional administrative burden on them, because they would be compelled to seek 'clear evidence' to support their assessment of the expected manner of recovery (Para 46 and 55);

    (b) the proposal does not represent faithfully the cash flows that will occur if the entity expects to recover part of the carrying amount through use and part through sale ('dual recovery intention') because the exception requires recovery to be either completely through sale or completely through use (Para 43); and

    (c) possible unintended consequences.

13. However, alternative A is a practical approach that aims to achieve a result that is similar to, but not exactly same as, the entity's expectation. Some respondents may have additional burdens as a result of the exception. However, alternative A may be appropriate if the Board believes that benefits in jurisdictions where the practice issue exists outweigh additional burdens in other jurisdictions.

Alternative B (narrow scope exception)

14. Many respondents are concerned that additional burdens and unintended consequences would occur when an entity needs to rebut the presumption (Para 43 and 45). An entity needs to rebut the presumption when it expects to recover the underlying assets by use rather than sale.

15. Many respondents said that the fair value or revaluation measurement basis does not imply or predict recovery through sale (Para 37). However, many respondents agree that it is often appropriate to presume recovery by sale if the underlying asset is investment properties measured using the fair value model in IAS 40 (Para 23). Many respondents, however, disagree with the presumption of recovery by sale if the underlying assets are property, plant and equipment. They believe that many assets in this category are recovered by use rather than sale. They also said that the recovery through use is consistent with the definition of property, plant and equipment in IAS 16 (Para 26). Many respondents also disagree with the presumption of recovery through sale when the underlying assets are intangible assets because of the same concerns expressed above regarding revalued property, plant and equipment. They also warned of the varying and different natures of intangible assets (Para 29 and 30). Many respondents who did not support the exception indicated that they would support limiting the scope of the exception to investment properties measured using the fair value model in IAS 40 if the Board proceeds with the exception (Para 22).

16. Considering those comments, it is probably not appropriate to presume recovery through sale for property, plant and equipment and also for intangible assets. Presuming recovery through use for those assets will not solve the practice issue either, because the practice issue occurs when an entity expects to recover the carrying amount of those assets through sale rather than use. This suggests to supporters of Alternative B that the Board should exclude those assets from the scope of the exception rather than presume recovery by sale or other manner of recovery for those assets.

17. The primary issue in most jurisdictions relates to investment properties subsequently measured at fair value (BC14 of the ED). Only respondents from

New Zealand focused on the practice issue involving property, plant and equipment (Para B7).

18. The issue in New Zealand should be separate from the issue that the Board is solving by this proposal. It is not an issue caused by difficulty and subjectivity in determining the expected manner of recovery. It is an issue relating to the double counting of tax effects. Therefore, supporters of Alternative B conclude that the Board should focus on investment properties and should not extend the scope of the exception to other assets.

19. Some respondents suggest including owner-occupied properties that are held for both use and sale even though they are accounted for in accordance with IAS 16 (Para 28). However, inclusion of owner-occupied properties would give rise to further questions on other types of assets in the same category. Because owner-occupied property is still subject to the definition of property, plant and equipment that requires assets to be held for use, supporters of Alternative B conclude that it should be excluded from the scope.

Alternative C (application guidance)

20. Many respondents are concerned about introducing another exception into IAS 12. They believe that application guidance would address many of the same problems as the proposed exception while providing a more operational solution that would be appropriate in the context of principles-based standards (Para 13).

21. The staff note that the Board's reason for creating another exception in IAS 12 was not to produce a result that would contradict the entity's expectation. The Board proposed a rebuttable presumption of recovery by sale in specified situations in order to reflect the entity's expectation in the least subjective manner. If so, a similar result can possibly be achieved by developing application guidance.

22. Many respondents are concerned about the additional burden that would occur when an entity needs to rebut the presumption. Many respondents are concerned by a result that contradicts with an entity's expectation when the presumption of recovery through sale is used (Para 43 and 46). Those concerns relate mainly to

property, plant and equipment but there are some assets in that category which are recovered through sale rather than use (eg owner occupied property held for use and also for capital appreciation). Application guidance does not need to use the rebuttable presumption and does not need to define the scope. Therefore, it can avoid those concerns. In fact, many respondents who prefer application guidance to an exception see no need to define the scope if the Board develops application guidance rather than an exception. (Para 21 (a)).

23. Supporters of Alternative C believe that the Board should develop application guidance. That guidance should focus on revalued property and investment property carried at fair value in order to incorporate SIC-21 into IAS 12 (see discussion in Issue 3). The application guidance will avoid creating another exception in IAS 12. It can also avoid additional burden and a result that contradicts with the entity's expectation.

Issue 2: Measurement base

Alternative A (an exception as proposed in the ED)

24. The staff understand that the approach the Board proposed in the ED was to include not only investment property but also property, plant and equipment and intangible assets in the scope and then to exclude some of them by rebuttal of the presumption. By doing so, the Board aimed to solve similar issues involving property, plant and equipment and intangible assets rather than leaving them unresolved.

25. Under Alternative A, the Board would continue to use the same approach and the presumption of recovery through sale for all assets included in the scope of the exception.

26. Many respondents were concerned that the proposed exception would increase the administrative burden on entities that would need to gather 'clear evidence' to support a conclusion that recovery will be through use rather than sale (Para 46 and 55). They were also concerned that the presumption of recovery by sale may result in accounting that that is not consistent with the entity's expectation. Many respondents suggested to reword the rebuttable presumption so that the

threshold is lowered and an entity is able to continue to reflect the tax consequences of both use and sale (Para 43).

27. However, supporters of alternative A believe that the Board should not reword the presumption and should not lower the threshold. Practice issues involving property, plant and equipment occur mainly in New Zealand (Para B7). In view of their concerns about lack of discounting long-term deferred tax liabilities and double counting some tax effects, respondents from New Zealand support raising, rather than lowering, the threshold for rebutting the presumption (Para 44 and B8-B10) in order to solve their practice issue. If the Board lowers the threshold, there is not much purpose in extending the scope of the exception to property, plant and equipment and intangible assets.

Alternative B (narrow scope exception)

28. Under Alternative B, the Board would continue to use the presumption of recovery through sale for investment properties carried at fair value.

29. Many respondents argued that selecting an accounting policy of measuring the underlying asset at fair value does not imply or predict recovery through sale (Para 37). However, if the scope is limited to investment properties, many respondents agree with the presumption of recovery through sale because, even if an investment property earns income through rental use in a given period, the value or future earnings capacity of the investment property will not decrease and that value will ultimately be recovered through sale (Para 23). Therefore, under Alternative B, the Board should continue using the rebuttable presumption of sale.

30. Many respondents were concerned about additional administrative burdens and contradictory results that could be produced by the current wording of the rebuttable presumption. Many respondents thought ‘clear evidence’ is problematic because it:

(a) is an ambiguous term (Para 45);

(b) adds an unfair burden on entities that have no problem applying the existing principle in IAS 12 (Para 46); and

(c) possibly leads to abuse by entities that choose whether to gather clear evidence to achieve a favourable result (Para 47).

31. Under this alternative, the Board would consider rewording the threshold to remove or alleviate those concerns. The ED currently states:

> … if an entity has clear evidence that it will consume the asset's economic benefits throughout its economic life, this presumption is rebutted and …

32. In the 24 August 2010 extra Board meeting, some Board members suggested the staff consider an entity's business model, similar to the approach used in IFRS 9 *Financial Instruments* [1] rather than the clear evidence used in IAS 40.[2] The staff considered the use of a business model approach but did not use it in the ED. That was because the business model notion would not be operational when an asset in question was not used for the entity's core business.

33. However, if the scope of the exception is narrowed to investment property only, the use of the entity's business model would be more operational because IAS 40 defines investment property based on an entity's business model to generate independent cash flow from rental income, from capital appreciation or both. The staff think that the use of the business model notion can avoid the concerns discussed in paragraph 30. Therefore, the staff propose to redraft the rebuttable presumption to use the business model rather than clear evidence.

34. After the redrafting, the rebuttable presumption will be worded as follow:

> … if the asset is held for a business model whose objective is to consume the asset's economic benefits throughout its economic life, this presumption is rebutted, …

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[1] IFRS 9.4.2 states that a financial asset shall be measured at amortised cost if both of the following conditions are met:

(a) the asset is held within a business model whose objective is to hold asset in order to collect contractual cash flows.

(b) …

[2] IAS 40.53 states that there is clear evidence when, and only when, comparable market transactions are infrequent and alternative reliance estimates of fair value (for example, based on discounted cash flow projections) are not available.

Alternative C (application guidance)

35. Many respondents were concerned that the presumption of recovery by sale may result in accounting that that does not reflect the entity's expectation of recovery partly through use and partly through sale (dual recovery) (Para 43). Some respondents offered alternative criteria for deciding how to determine the expected manner of recovery (Para 38 and 39), such as:

    (a) recovery through use;

    (b) an entity's business model and past practice of recovering assets;

    (c) the depreciation assumption made for depreciable assets;

    (d) the principal manner of recovery; or

    (e) the manner of recovery that would result in lower tax consequences.

36. The staff believe that (a), (d) and (e) are not appropriate to be used in application guidance because none of them would permit an expectation of dual recovery (ie recovery partly through use and partly through sale) to be reflected in the measurement of deferred taxes.

37. The staff considered basing the measurement on the entity's business model (b) because it would provide a result that is more consistent with the entity's expectation. However, the staff believe that the business model notion would be less operational when application guidance is applied to a broad range of assets including property, plant and equipment and intangible assets. If the assets in question are not used for the entity's core business, the entity's business model may not be specific enough to determine the expected manner of recovery.

38. Some respondents suggested the Board develop application guidance in a manner that is consistent with various assumptions used for depreciation (c). This would be consistent with the Board's statement in paragraph BC12 of the ED that:

    > ... there is a general presumption that the asset's carrying amount is recovered by use to the extent of the depreciable amount and by sale to the extent of the residual value.

39. Other respondents suggested basing the guidance on whether an asset is depreciated or not depreciated. This is slightly different from the above presumption in BC12. These respondents argue that the term 'non-depreciable assets' should include both assets that are non-depreciable by nature (eg land) and assets that are not deprecated because standards prohibit depreciation (eg intangible assets with an indefinite life) (Para 36).

40. The staff think that this argument is similar to thinking that the generation of rental income should not be viewed as resulting in any 'use' of the asset in the normal sense of the term when the earning of rental income in a particular period will not necessarily change the value of the property. When an asset is not depreciated because it has an indefinite life, the generation of rental income does not appear to reduce the future economic benefits on which the asset's value is computed. Therefore the generation of rental income does not result in the normal sense of recovery by use.

41. When determining the expected manner of recovery, the value should be driven by 'future economic benefit' without considering the volatility in the market. The staff believes that the generation of rental income results in whole or partial 'use' of the asset when the future economic benefits embodied in the asset decrease as a result of receiving rental income – for example, if the asset has a finite life, as opposed to an indefinite life.

42. The staff believe that the application guidance need not refer to clear evidence. It should be obvious from facts and circumstances. The deferred tax should reflect the tax consequences of recovery through use to the extent that the generation of rental income results in recovery of the carrying amount of the asset through 'use'. If an entity expects that the future economic benefits embodied in the asset will decrease as a result of generating rental income, the entity must implicitly be relying on rental income to recover the part of the carrying amount that will be eliminated as a result of generating the rental income.

43. The staff believe that it is appropriate within alternative C to develop application guidance using the notion of 'decrease in the future economic benefits embodied

in the asset as a result of generating income from using that asset'. By doing so, the application guidance will create a result that reflects the normal sense of the recovery by 'use'.

44. However, supporters of Alternative A and Alternative B could possibly argue that the application guidance based on 'decrease in the future economic benefits embodied in the asset as a result of generating income from using that asset' does not solve the practice issue involving the difficulty and subjectivity in determining the expected manner of recovery. The difficulty and subjectivity exist because, before considering the time value of money, an entity receives cash flows that exceed the carrying amount of the underlying asset. Some could argue that there is no conceptual basis in IAS 12 to determine which future cash flow represents recovery of the carrying amount of the asset. This practice issue would not be resolved within the principle of IAS 12, and an exception would have to be created.

Issue 3: Withdrawal of SIC-21

Alternative A (an exception as proposed in the ED)

45. SIC-21 is applied to revalued non-depreciable assets. It is also applied to investment properties carried at fair value under IAS 40. If the Board goes ahead with the exception without narrowing the scope, the exception will cover all assets explicitly included within the scope of SIC-21. Therefore, if the Board adopts alternative A, it should withdraw SIC-21.

Alternative B (narrow scope exception)

46. Many respondents said that SIC-21 is applied by analogy to other assets such as land carried at cost and intangible assets with indefinite life. If the Board withdraws SIC-21, entities will no longer be able to apply SIC-21 to those assets by analogy. Many respondents suggested to retain SIC-21 or incorporate it into IAS 12 (Para 57).

47. If the Board excludes revalued property, plant and equipments from the scope of the exception, there is no overlap with the scope of SIC-21 except for investment properties carried at fair value in accordance with IAS 40.

48. Therefore, within alternative B the Board should retain SIC-21 but exclude from the scope of SIC-21 investment properties measured using the fair value model in IAS 40.

Alternative C (application guidance)

49. If the Board develops application guidance, the staff propose to incorporate SIC-21 into that guidance within IAS 12.

Issue 4: Assessment of deferred tax asset

Alternative A (an exception as proposed in the ED)

50. Paragraph 51D of the ED states:

> Paragraphs 51B and 51C do not change the requirements to apply the principles in paragraphs 24−31 (Deductible temporary differences) and paragraphs 34−36 (Unused tax losses and unused tax credits) of this Standard when recognising and measuring deferred tax assets.

51. Some respondents requested more clarification on the reassessment of the recoverability of deferred tax assets as stipulated in paragraph 51D of the ED (Para 52).

52. They were particularly concerned about an inconsistency that could possibly arise when realisation of a deferred tax asset arising from deductible temporary differences or unused tax losses depends solely on taxable profits from recovery of the underlying asset through use.

53. For example, assume the carrying amount of a building, for which an entity has chosen the accounting policy of revaluing the building, is CU100. Assume under tax law no deductions are available from using the building and the proceeds on the sale of the building are non-taxable. The tax rate applied to rental income is 30%. Also assume that the entity has a tax loss of CU80 whose recovery is solely dependent on taxable profits from using the building. There is

a taxable temporary difference of CU100 because tax deductions are not available from using the asset. The entity currently recognises a deferred tax liability of CU30 (100 at 30%) based recovery of the building through use and recognises a deferred tax asset of CU24 (CU80 at 30%) based on future rental income from the building. Under the proposals in the ED, the entity would recognise no deferred tax liability because recovery of the building through sale is non-taxable (assume the presumption is not rebutted) but it continues to recognise a deferred tax asset of CU24 based on future taxable profit from renting the building. The respondent thinks that the resulting net deferred tax position would not reflect net tax cash outflow from renting the building in the future.

54. The staff do not agree with this argument. IAS 12 does not require recognition of *net* tax cash flows from recovery of the underlying asset as a deferred tax liability. It requires separate recognition of a deferred tax asset for unused tax losses and a deferred tax liability for taxable temporary differences and permits offsetting them only when specific conditions in IAS 12.71 – 76 are met. Proposed paragraph 51D provides sufficient clarity. The principle in assessing a deferred tax asset should continue to apply.

Alternative B (narrow scope exception)

55. The staff do not think additional guidance or special treatment is necessary. Proposed Paragraph 51D provides sufficient clarity. The concern raised by respondents is valid if the exception produces a situation in which the amount of deferred tax liability does not reflect the entity's expectation. However, such situations will be rare if the scope of the exception is narrowed and the rebuttable presumption is reworded.

Alternative C (application guidance)

56. The staff think that the proposed Paragraph 51D should be removed. The application guidance does not change the principle and does not create a situation in which the amount of deferred tax liability does not reflect the entity's expectation. Therefore, the proposed paragraph 51D is not necessary.

Issue 5: Disclosure requirement

Alternative A (an exception as proposed in the ED)

57. Many respondents stated that the proposed disclosure requirement is costly and does not add any value to the financial statements (Para 56). Paragraph 81(l) of the ED states:

    > (l) if the entity has rebutted the presumption in paragraph 51B, a description of that fact and an explanation of why the presumption was rebutted.

58. The staff was convinced that the proposed disclosure would not add as much value to the financial statements as the costs of the preparers who will have to rebut the presumptions in order to reflect tax consequences of recovery through use to deferred tax liability or deferred tax asset. Since IAS 1 *Presentation of Financial Statements* already requires disclosure of material judgements, there is no need to require disclosure of a particular judgement on specific types of assets. The staff, therefore, propose to remove the disclosure requirement under Alternative A.

Alternative B (narrow scope exception)

59. The staff propose to remove the disclosure requirement for the same reason as discussed under Alternative A.

Alternative C (application guidance)

60. The staff do not think a disclosure requirement is necessary if the Board introduces application guidance without a change in the principle.

Issue 6: Full retrospective application

Alternatives A, B and C

61. Some constituents think a transition provision is necessary for previous business combinations (Para 51) because:

    (a) Hindsight may be involved in reassessment of:

(i) deferred tax assets as a result of reduction of a deferred tax liability; and

(ii) impairment of goodwill as a result of increase or decrease (or sometimes creation) of goodwill acquired in previous business combinations.

(b) Some information necessary to restate previous business combination may no longer be available.

62. Some respondents question whether a change from the proposed amendment would be considered a change in accounting estimate of the expected manner of recovery or a change in accounting policy (Para 50).

63. The staff think that if an entity changes its accounting for income taxes as a result of applying the proposed amendment, it reflects a change in accounting policy rather than a change in accounting estimate. This is because the term *Accounting Policy* includes not only the specific principles, bases or rules but also the specific practice in preparing and presenting financial statements. The staff think that the introduction of new application guidance, or a new exception, should also be considered a change in accounting practice in determining the expected manner of recovery rather than a change in accounting estimate.

64. The staff considered the concerns on retrospective application to previous business combinations. Many respondents stated that the information necessary for the restatement on goodwill and on each component of equity relating to previous business combinations may no longer be available. Some respondents also stated that it is difficult to separate the effect of hindsight that may be involved in assessment of goodwill and deferred tax assets acquired in previous business combinations (Para 51).

65. The staff are not convinced by these arguments. The proposed exception will generally reduce a deferred tax liability, and therefore reduce goodwill if it is acquired in a business combination. It will also reduce a deferred tax asset if its realisation is dependent on taxable temporary differences to which the proposed exception applies. It generally does not increase or newly create goodwill or a deferred tax asset; therefore does not require additional judgement or new information on which their recoverability is determined.

66. The proposed exception could possibly increase a deferred tax liability, thereby increasing goodwill. It could possibly increase a deferred tax asset as a result of presuming recovery of underlying asset through sale. In such cases, retrospective application of the proposed exception may be impracticable because additional judgement or new information is necessary to assess recoverability of goodwill or a deferred tax asset.

67. However, the staff believe that such situations are unlikely to happen in most jurisdictions. Even if such a situation happens, paragraphs 24 and 25 of IAS 8 provide sufficient guidance to deal with the cases of impracticability. The staff do not believe that any transitional provision is necessary relating to previous business combinations.

Issue 7: Timing of recovery by sale

Alternative A, B and C

68. Some respondents requested guidance regarding how the timing of recovery through sale should be taken into account for deferred tax calculation (Para 36). The staff noted that some respondents also misunderstood that the proposal would assume *immediate* sale at the end of reporting period.

69. The staff understand that IAS 12 requires an entity to use tax rates that are expected to apply to the period when the asset is realised or the liability is settled (IAS12.47). IAS12.52 requires determining the expected manner of recovery, whether use or sale. It does not change the timing of recovery from the entity's expected timing. The staff propose amending the illustrative example following paragraph 51B to clarify that the tax rate used is the tax rate that will apply at a future sale date.

Other issues

An issue of a single asset entity

70. Many respondents asked the Board to address the issue of an entity wrapper (Para 54).

71. The staff acknowledge that entities often hold property through entity wrappers for both tax and other reasons. Therefore, if the Board wished to address all aspects of accounting for investment property, it would need to deal at some point with entity wrappers as well. Nevertheless, the staff do not believe that the Board should address entity wrappers in this amendment because the staff believe that the issue is separate from the issue that the Board is trying to solve by this amendment.

72. The staff has summarised its analysis of the issue of an entity wrapper in Appendix A.

An issue of double counting tax effect

73. Respondents from New Zealand welcome the proposal but request further amendment or extension of the scope of the exception to assets using the cost model (Para B8). Their requests include:

    (a) inclusion of property, plant and equipment measured using the cost model in the scope; and

    (b) not allowing the presumption of sale to be rebutted.

74. The staff think that the practice issue in New Zealand is separate from the issue that the Board is trying to resolve by this amendment. In New Zealand, due to the recent tax law change to prohibit tax depreciation for buildings with expected lives of 50 years or more, entities in New Zealand lost the tax base of those buildings and were forced to recognise large amounts of deferred tax liabilities based on their expectation to recover these assets through use. When entities have chosen the accounting policy of revaluing the buildings at fair value, many times, the fair value already includes the tax effects of using the asset that include the tax effect of the loss of tax deductions as a result of the recent tax law change. Those entities argue that these tax consequences will never be realised and are in effect counted twice (Para B8 and B9).

75. The primary issue in New Zealand does not relate to difficulty and subjectivity in determining the expected manner of recovery. Rather it relates to the discounting of deferred taxes and the double counting of tax effects. Although

the proposal in the ED (therefore, Alternative A) would avoid the double counting of tax effects in some cases, it does not solve the problem completely. Moreover, unlike Alternative A, **Alternative B would not address the double counting issue for revalued property, plant and equipment.** **Alternative C** addresses the revalued property, plant and equipment but would not presume the recovery through sale, and therefore **would not solve the double counting issue as much as Alternative A**. As a reminder, this issue arises particularly in New Zealand because revaluation of property, plant and equipment is common in New Zealand and because there is no capital gains tax there. (None of the proposed Alternatives A, B or C would address another concern expressed by New Zealand respondents: the possible double counting issue for property, plant and equipment carried at depreciated cost).

76. Some respondents suggested that the staff proposal in the March 2010 Board meeting would be a better way to solve the double counting issue (Para 19). In the March 2010 Board meeting, the staff proposed to extend the initial recognition exception to the subsequent remeasurement at fair value to the extent that market participants would have the same temporary difference.

77. If the Board wishes to solve the double counting issue comprehensively, the staff propose that the Board considers developing a proposal to solve the double counting issue based on the staff proposal in the March 2010 Board meeting. This proposal could represent the next amendment to IAS 12. However, there would still be a need for full due process for the potential amendment.

78. The staff has provided a summary of the staff proposal in March 2010 in Appendix B.

Land appreciation tax in People's Republic of China

79. In People's Republic of China, there is a land appreciation tax that applies to entities and individuals receiving income (ie proceeds less deductions) from the transfer of State-owned land use rights, buildings, and the attached facilities. Respondents from China expressed concern over whether the proposed amendment would also be applied to the land appreciation tax, thereby increasing deferred tax liabilities of Chinese entities (Para B4).

80. The staff was advised by an accounting firm in China that the land appreciation tax was not considered income tax under IAS 12 in practice, although the staff has not confirmed whether it is a pervasive view in China or whether there is a diversity in practice.

81. The staff believe that, if there is a diversity in practice, it should be discussed by the IFRS Interpretation Committee in the context of IAS 12 rather than the Board project on Income Tax. The staff do not believe that the Board needs to address this issue in this amendment.

Questions to the Board

Questions 1 for the Board
1. Does the Board agree with the staff recommendation to take Alternative B for addressing the major issues raised by commentators included in this agenda paper?

Questions 2 for the Board
2. Does the Board wish to make any changes to the staff proposals in Alternative A, B or C?

Next steps

82. The staff will reflect the Board decisions today in the pre-ballot draft and circulate it during the week of 6 December and will circulate the ballot draft a week later, with the aim of receiving all ballots from Board members by 16 December 2010

83. The aim is to publish the final standard before the end of this year.

84. Two respondents in Canada have specifically stated in their comment letter that the effective date of this amendment is very important to entities in jurisdictions where IFRSs will be adopted effective from 2011. They ask the Board to introduce the amendment before the end of this year or at least to announce the

effective date by mid December this year in order to reduce their administrative burden to adopt IFRSs from 2011.

85. The finalization of this amendment before the end of this year is important not only to solve this issue without further delay, but also to reduce the administrative burden on entities that will adopt IFRSs from 1 January 2011.

Appendix A – the staff analysis of the single asset entity issue (also known as an entity wrapper)

Purpose of this paper

A1. This paper discusses deferred tax consequences of a single asset entity. That entity is a shell company that owns a single investment property. The shell company structure is often used in some jurisdictions in order to benefit from tax exemption on the sale of shares and from other legal treatments. This type of arrangement is also known as an entity wrapper.

A2. This appendix contains:

(a) A staff recommendation

(b) An explanation of the issue

(c) Current practice

(d) Alternatives

(e) Staff analysis of the alternatives

Staff recommendation

A3. The staff recommends that the Board does not address this issue in the proposed amendment to IAS 12, nor should it take this issue onto the list of practice issues to be solved in the Board project on income tax. The staff thinks that this issue is not just an income tax issue. This issue should be addressed in the context of other IFRSs dealing with intangible assets, fair value measurement and consolidation.

Explanation of the issue

A4. In some jurisdictions, some types of assets are often acquired in the form of shares of a legal entity because there is a tax or other advantage in selling the shares rather than selling the underlying asset. There is considerable debate

about whether deferred tax should be recognised for a temporary difference arising on the asset within that legal entity.

A5. For example, real estate investment company A owns real estate. The real estate is held in the form of an entity wrapper to get the tax or legal benefits. A accounts for the acquisition of the entity wrapper as asset acquisitions, not business combinations. The real estate is accounted for using the fair value model of IAS 40. Hence, any revaluation gains and losses are recorded in profit or loss. Subsidiary B is one of those entity wrappers. The local tax rate applicable to B is 30% on any profit (capital gain or rental income), regardless of whether it sells or rents out the asset. If A sells the shares of B, then a tax rate of 0% would be applied on the difference between the tax base of the shares and the sales price. Does A have to account for the taxable temporary difference between the carrying amount of the real estate and its tax base in the books of B if it intends to sell the asset by selling the shares of B?

Current practice

A6. Under the current IAS 12, if the acquirer concludes that the acquisition of an entity wrapper is an asset acquisition, not a business combination, the initial recognition exception in paragraph 15(b) of IAS 12 applies to the asset acquired through the acquisition of the entity wrapper.

A7. Assume A acquires the shares of B for CU100. B's sole asset is a property with a tax base of CU60 and a carrying amount of CU100, and hence a taxable temporary difference of CU40 (tax deductions are available to B only for B's acquisition cost of CU60). A accounts for the property at CU100 with credit to cash CU100. A would not recognise a deferred tax liability for the taxable temporary difference because of the initial recognition exception (As stated in the above example, the transaction is not regarded as a business combination. Therefore, the initial recognition exception applies.)

A8. Later, A revalues the property to CU120 when the tax base of the property has reduced to CU50 (assume B has claimed a tax deduction of CU10). There is a taxable temporary difference of CU70 (CU120-CU50=CU70) which includes the initial temporary difference of CU40. A would be required to recognise a deferred tax liability for the additional temporary difference of CU30 (CU70-CU40=CU30) based on how B expects to recover the carrying amount of the property (the deferred tax liability would be CU30*30%=CU9).

Alternatives

A9. Some constituents argue that in the situation above, A should not be required to recognise a deferred tax liability at all if A expects that it would sell the shares of B if it wants to liquidate the investment in the property, rather than selling the property out of B. They argue that the manner in which the entity expects to recover or settle the carrying amount of its assets or liabilities includes the type of sale (ie sale of the entity wrapper or sale of the underlying asset). In addition, they note that market participants would typically sell the shares of B if they want to liquidate the investment in the property, rather than selling the property out of B.

A10. Others could argue that it is A, not B, which will receive the tax benefit from the entity wrapper scheme. While B should recognize a deferred tax liability for a temporary difference related to the property in its individual financial statements, A should recognise an intangible asset which represents the tax benefit from the entity wrapper scheme. By doing so, B's deferred tax liability is effectively set off, at least to some extent, by A's intangible asset.

A11. In addition, the staff has considered the treatment under US GAAP. US GAAP does not specifically discuss this issue but provides an example in a similar case. According to that example, A would calculate the carrying amount of the property and recognise a deferred tax liability using the simultaneous equation method (ASC Topic 740-10-55-177 - 182). Under the simultaneous equation method, the carrying amount of the property is adjusted so that the adjusted

carrying amount less deferred tax asset or liability equals the consideration paid. In the above example, the adjusted carrying amount is CU117[3] at the initial recognition and CU150[4] at the subsequent revaluation.

Staff analysis of the alternatives

A12. By acquiring the property by acquiring shares in B instead of directly, A has taken on a different tax position. If it had bought the property directly, it would pay tax on any rental income or sales proceeds in excess of A's cost. By buying the shares in B, it will:

(f) pay tax on any rental income or proceeds of sale by B in excess of B's tax base (ie A retains B's tax base, which is a disadvantage compared to a direct acquisition of the property) but

(g) pay no tax on the sale of the property by selling the shares in B (ie an advantage compared to the direct acquisition of the property).

A13. The staff thinks that a core question in this issue is the fair value of the underlying asset. Has A reflected the fair value of the underlying asset appropriately in its financial statements?

A14. Current practice may not reflect the fair value of the underlying property appropriately. Under current practice, A is assuming that the fair value of the shares of B equals the fair value of the underlying property because the fair value is available only in a market in which shares of the entity wrapper are traded.

A15. However, the fair value of the underlying property is not the same as the fair value of shares of the entity wrapper. Since the entity wrapper scheme provides specific tax and other benefits to investors, the fair value of the shares of an entity wrapper should be higher than the fair value of the underlying asset by the

[3] CA–DTL=100, DTL=(CA-60)*30%; CA(carrying amount)=117, DTL(deferred tax liability) =17
[4] CA-DTL=120, DTL=(CA-50)*30%; CA(carrying amount)=150, DTL(deferred tax liability) =30

fair value of those benefits. It should however be lower by the amount of tax that a seller would otherwise have to pay if it sells the underlying asset directly.

A16. Putting aside the recognition criteria in IAS 38 *Intangible assets*, A should have acquired an 'asset' that represents those tax and other benefits from an entity wrapper. On the other hand, because A has acquired the property with a tax base that is disadvantageous to other market participants, A should recognise a deferred tax liability relating to the underlying property together with that 'asset' representing those tax and other benefits.

A17. Current practice is mixed, resulting in inconsistencies. On initial recognition, the initial recognition exception results in no amount of the purchase consideration being separately attributed to the temporary difference in B. IAS 38 generally does not permit to recognise an asset representing any tax and other benefits given by the entity wrapper scheme. As a result, A recognises the underlying asset at the fair value of shares in B. But on subsequent remeasurement, A recognises a deferred tax liability for the incremental temporary difference, without recognising any asset for the tax advantage given by the entity wrapper.

A18. The staff has identified the following alternative approaches to recognise those assets and liabilities and illustrated in tables below the amounts that would be recorded initially and subsequently:

(a) An approach under current practice

(b) An approach to disregard the underlying property (therefore account for the shares of B as a single asset)

(c) An approach to recognise an asset representing tax and other benefits

(d) An approach used in US GAAP

Initial recognition

	An approach used in current practice	An approach to disregard the underlying property	An approach to recognise intangible assets [5]	An approach used in US GAAP
Property	100	0	100	117
A single asset of shares in a wrapper		100		
Deferred tax liability	0	0	(12)	(17)
Intangible: tax benefit of shell company structure	0	0	12	0

Subsequent revaluation

	An approach used in current practice	An approach to disregard the underlying property	An approach to recognise intangible assets [6]	An approach used in US GAAP
Property	120	0	120	150
A single asset of shares in a wrapper		120		
Deferred tax liability	(9)	0	(21)	(30)
Intangible: tax benefit of shell company structure	0	0	21	0

A19. As noted above, current practice is inconsistent in its approach to the initial temporary difference and the temporary difference arising on subsequent remeasurement. The staff thinks that a model used in US GAAP is also not appropriate because the amount reported in the balance sheet is neither the fair value of the property nor the fair value of the shares.

[5] The figures in this column assume that the tax benefit of the shell company structure exactly offsets the effect of B’s temporary difference. This will not always be the case.
[6] The figures in this column assume that the tax benefit of the shell company structure exactly offsets the effect of B’s temporary difference. This will not always be the case.

A20. The staff thinks that either an approach to disregard the underlying property or an approach to recognise an intangible asset would give reasonable results. However, an approach to disregard the underlying property is difficult to apply without changing the requirements in other IFRSs regarding consolidation.

A21. The staff also note that an approach to recognise intangible asset is also difficult to apply without changing the recognition criteria in IAS 38. The staff note that the only observable value is the fair value of the shares. In some tax jurisdictions the property is never traded except in the form of an entity wrapper. Also, the value of the tax benefit given by the entity wrapper may not equal the effect of B's temporary difference. Its value will depend on the entity's expectations about the manner of recovery of the property which will affect how much tax benefit the entity wrapper provides. So, even if IAS 38 permits recognising intangible asset for tax and other benefits provided by the entity wrapper, determining the amounts to be recognised as intangible asset could be challenging.

A22. The staff think that the staff proposal in the March 2010 Board meeting (see Appendix B) to extend the initial recognition exception to subsequent remeasurement could possibly provide a solution to this issue, subject to further research and analysis.

A23. Thus, the staff think that this issue is to be dealt with not just in the context of IAS 12 but also in the context of other IFRSs. The staff believe that this is an issue that is separate from an issue that the Board is trying to solve in this amendment. Therefore, the staff think that it is not appropriate to address this issue in this amendment.

Appendix B – a summary of the staff proposal in March 2010 to solve the double counting of tax effects

Summary

B1. The staff recommended in the March 2010 Board meeting that an exception be added to IAS 12 so that an entity does not recognise deferred tax on temporary differences on assets and liabilities if:

(a) the assets and liabilities are measured at fair value and

(b) a market participant acquiring the asset or assuming the liability for its fair value would have the same temporary differences.

B2. This means that an entity:

(a) would continue to recognise deferred tax on temporary differences arising from remeasurement of assets and liabilities to the extent of any entity-specific temporary differences, but

(b) would not recognise deferred tax liability arising from temporary differences that are common to market participants.

The staff analysis

B3. Some respondents argue that the fair value of a property already includes some tax effects in some circumstances and hence it is misleading to recognise a deferred tax liability in those cases. In addition, the staff notes that there may be a connection between this issue and the treatment of a temporary difference arising on the initial recognition of an asset.

B4. Consider the following example of the initial recognition exception.

B5. An entity purchases an investment property for CU120. Tax deductions are available only to the extent of the original development cost of CU100, so there is an initial temporary difference of CU20 under IAS 12. Without the initial recognition exception, the entity would have to adjust the carrying amount of the investment property to CU129 using a simultaneous equation method (assuming

the tax rate is 30%)[7] and recognise a deferred tax liability of CU9. However, IAS 12 requires an entity to recognise the investment property at CU120 without any deferred tax liability. IAS 12 states that it is more transparent to show the carrying amount of the asset as CU120 without any tax liability than as CU129 with a deferred tax liability of CU9.

B6. We could apply similar thinking in a subsequent revaluation. Suppose an entity had acquired an investment property at a cost of CU105 (equal to its fair value at the date of acquisition). Suppose also that the tax base at initial recognition is only CU100, as in the previous paragraph.

B7. Some years later, suppose the entity has claimed tax depreciation of CU40 (resulting in a tax base of CU60) and has remeasured the investment property to its current fair value of CU120. Currently, IAS 12 requires an entity:

(a) not to recognise the deferred tax liability arising at initial recognition from the taxable temporary difference of CU5 at that date.

(b) to recognise a deferred tax liability of:

(i) CU4.5 ((20-5)*30%=4.5) [8] for the difference of CU15 that arises after initial recognition.

(ii) CU12 (40*30%=12) for a temporary difference of CU40 resulting from past depreciation claimed for tax purposes.

B8. Market participants acquiring the asset at CU120 would receive tax deductions of the original cost of CU100 and would measure the asset at CU120 with no deferred tax liability. The following table summarises this example.

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[7] This assumes that the entity uses the grossing up method required by EITF 98-11. CA-DTL=100, DTL=(CA-100)*30%, CA(carrying amount)=129, DTL(deferred tax liability)=9

[8] The temporary difference of 5 that arose on initial recognition is covered by the initial recognition exception.

	Initial recognition	Subsequent revaluation
Carrying amount	105	120
Tax base of market participants	100	100
Tax base of the entity	100	60
Temporary difference:		
- Entity specific	0	40
- Arising for other market participants	5	20

B9. The staff thinks that this is the situation that causes some constituents to argue that the tax effect is double counted. The carrying amount of CU120 includes the effect of the temporary difference that would exist for market participants, just as the initial carrying amount of CU105 did. The staff thinks that the entity should be required to recognise a deferred tax liability only for the entity specific temporary difference (CU40 in the above table).

B10. The staff thinks that this approach would provide consistency between accounting for income tax and fair value measurement. Further, it would not be a major change from the existing general approach in IAS 12 of looking at the expected manner of recovery. In addition, in the tax environments where this exception would be relevant, the same circumstances result in a temporary difference that is not recognised at initial recognition because of the exception in paragraph 15(b) of IAS 12. Thus, this approach would treat these circumstances consistently across initial recognition and subsequent measurement.

The Board decision in March 2010

B11. The Board rejected the staff proposal and directed the staff to explore the possibility of an exception for investment properties measured using the fair value model in IAS 40, based on the lower tax consequences of sale or use.

B12. Subsequently, the Board decided to use the rebuttable presumption of recovery through sale rather than the lower tax approach.

Appendix C

Major issues raised in the comment letters	Alternative A (an exception as proposed in the ED)	Alternative B (a narrow scope exception)	Alternative C (application guidance)
• Issue 1 Form of guidance	• An exception to be applied to (a) investment property measured using the fair value model in IAS 40, (2) property, plant and equipment and intangible assets measured using the revaluation model in IAS 16 or IAS 38, and (3) those assets that are initially measured at fair value in a business combination and subsequently measured using the fair value model in IAS 40 or the revaluation model in IAS 16 or IAS 38.;	• An exception to be applied to (a) investment property measured using the fair value model in IAS 40 and (2) those assets that are initially measured at fair value in a business combination and subsequently measured using the fair value model in IAS 40.	• Application guidance on the revalued property and on investment properties carried at fair value. •
• Issue 2 Measurement base	• Rebuttable presumption of recovery through sale. • The presumption is rebutted if an entity has clear evidence that it will consume the asset's	• Rebuttable presumption of recovery through sale. • The presumption is rebutted if the asset is held for a business model whose objective it to	• Guidance clarifies that the asset is recovered through use to the extent that the future economic benefits embodied in the asset decrease as a result of generating income from using

<table>
<tr><td></td><td>economic benefits throughout its economic life.</td><td>consume the asset’s economic benefits throughout its economic life.</td><td>the asset.</td></tr>
<tr><td>• Issue 3
SIC 21</td><td>• Withdrawn</td><td>• Amended to exclude from the scope of SCI-21 investment properties carried at fair value</td><td>• Incorporated into new guidance in IAS 12.
• New guidance can be applied to other assets by analogy when appropriate.</td></tr>
<tr><td>• Issue 4
Assessment of deferred tax asset</td><td colspan="2">• Retain proposed paragraph 51D.
• No additional guidance is necessary.</td><td>• Remove proposed paragraph 51D.</td></tr>
<tr><td>• Issue 5
Disclosure requirement proposed in paragraph 81(l) (fact of the rebuttal, and reasons for it)</td><td colspan="3">• Remove</td></tr>
<tr><td>• Issue 6
Full retrospective application</td><td colspan="3">• Retain</td></tr>
<tr><td>• Issue 7
Timing of recovery by sale</td><td colspan="3">• An illustrative example following the proposed paragraph 51B will be amended to clarify the timing of recovery by sale.</td></tr>
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