STAFF PAPER

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IASB Meeting

Project	**IAS 12 *Income Taxes* research project**		
Paper topic	Income Taxes Education Session		
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Purpose of this paper

1. The purpose of this paper is educational. It explains the background of the existing IFRS Standard on income taxes, IAS 12 *Income Taxes*, and the staff's findings from research work undertaken so far. Staff hope that this will help the Board to assess the priority of the Income Taxes research project in comparison to the priority of other research projects identified in the 2015 Agenda Consultation.

2. As the purpose of the discussion with the Board this month is educational, the staff will not ask the Board to make any decisions.

Question for the Board
1. Do Board members have any substantive comments on the issues discussed in this paper?

Introduction

3. As a result of the 2011 Agenda Consultation, the Board identified income taxes as one of three topics for long term research. Those projects were described, as follows, in the Feedback Statement on the 2011 Agenda Consultation:

> Projects for which, because of their nature and complexity, the Board did not plan to issue a Discussion Paper or research document within the next three years but would allocate staff to ensure that the information being gathered would be likely to benefit the Board when it was to take a more active role in the project.

4. In 2014, staff were allocated to the Income Taxes research project to gather information about the work already done by the other standard setters and conduct necessary follow-up work. The staff reviewed various documents published by other standard setters and academics and also conducted investor outreach as part of the follow-up work. (See Appendix B for Feedback from Investor Outreach and Appendix C for Investor Survey Questionnaire.)

5. In the 2015 Agenda Consultation, 63 respondents commented on the Income Taxes research project's priority.[1] 13 respondents ranked the project as high priority, 24 as medium priority and 26 as low priority. Please see Appendix D: 2015 Agenda Consultation for more detail.

6. In addition to the 2015 Agenda Consultation Request for Views, the staff simultaneously conducted a supplementary online survey. 13 respondents, including six groups representing users of financial statements, named income taxes as an area in which they would like to see the Board making improvements.

Structure of this paper

7. This paper contains the following sections and appendices:

    (a) Summary of research and outreach findings (paragraphs 8-14).

    (b) History of the Board's project on IAS 12 *Income Taxes* (paragraphs 15-24).

[1] Including four respondents from groups representing users, of which two prioritised the project as high priority and two prioritised it as low.

(c) Summary of principles in IAS 12 *Income Taxes* (paragraphs 25-30).

(d) Main application issues (paragraphs 31-62).

(e) Potential ways forward (paragraphs 63-78).

(f) Various Accounting Models for Income Taxes—Appendix A (Agenda Paper 19B).

(g) Feedback from the Investor Outreach—Appendix B (Agenda Paper 19C).

(h) Investor Survey Questionnaire—Appendix C (Agenda Paper 19D).

(i) Income Taxes feedback from the 2015 Agenda Consultation—Appendix D (Agenda paper 19E).

Summary of findings

8. The findings of the research and outreach conducted so far indicate that the practice issues arising in applying IAS 12 have three main causes. They are:

(a) Type One—the current model in IAS 12 produces information that some people consider is not particularly relevant and causes an accounting mismatch. While IAS 12 bases its principles on the 'balance sheet liability approach' (see paragraphs 11–14 of Appendix A), a number of people still believe that another approach would reflect the economics of income taxes more faithfully. These people often prefer an 'income approach' (see paragraphs 4–10 of Appendix A).[2] This is probably because, in their view, an income tax liability arises at the time when related income is recognised. In contrast, under the 'balance sheet liability approach', the general view is that a tax liability exists at the point when a recognised asset

[2] 'Income approach' in this paper means either 'income statement liability approach', or 'income statement deferred approach'. A more detailed explanation is provided in Appendix A.

(or a recognised liability) is measured at an amount that is different from the amount attributed to that asset (or liability) for tax purposes (ie its tax base). That difference would give rise to additional tax cash flows if the entity recovers the asset (or settles the lability) at its carrying amount (ie the amount on the balance sheet).

(b) Type Two—the current version of IAS 12 may not fit well with more recent IFRS Standards or more recent tax laws across the globe. This is especially the case when the related assets and liabilities are measured at fair value. The current version of IAS 12 was originally published by the International Accounting Standards Committee (IASC), the Board's predecessor, in October 1996, and resulted in a switch from the 'income approach' to the 'balance sheet liability approach'. At that time, only a few IFRS Standards either required, or permitted, subsequent remeasurement or revaluation of assets or liabilities to fair value. Although the IASC provided an exception from deferred tax accounting when an asset or liability was initially recognised, it did not provide an exception for similar cases in subsequent remeasurement or revaluation of assets or liabilities at fair value.

(c) Type Three—income taxes are very complex and existing disclosure may be insufficient to explain what drives the amount of income taxes reported. The staff often hear from users of financial statements that tax information is needed to project an entity's after-tax cash flows, as well as to determine an entity's financial soundness (ie credit worthiness). However, the way tax information is currently disclosed is often just a mathematical exercise that uses a great deal of technical jargon and, as a result, lacks transparency. Moreover, some users are sceptical about deferred tax accounting because they do not understand what information is provided when this method of accounting is used and they suspect that deferred tax accounting is utilised to manage earnings.

9. The staff think that there are five possible ways forward in order to address the practice issues mentioned above. Each is considered in more detail in paragraphs 63-78.

Option 1: Fundamental change of the main principle in IAS 12

10. The Board could undertake a project to consider whether to fundamentally change the main principle currently used in IAS 12. For example, the Board could consider changing from the balance sheet liability approach to another approach, if doing so would make financial information more relevant without causing excessive costs for users or preparers (see Appendix A for alternatives).[3]

Option 2: Narrow-scope amendments to address some practice issues

11. The Board could undertake narrow scope amendments to address several of the issues that arise in practice. For example, when an asset is re-measured at fair value, some tax effect is already reflected in the fair value. As a result, some people think that, when an asset is measured at fair value, recognising a separate deferred tax liability would, in some situations, double-count the same tax liability. In these cases, the Board could create an exception that is similar to the 'initial recognition exception' in paragraph 15 of IAS 12, and apply that exception to some cases of subsequent fair value measurement (see paragraph 45).

Option 3: Improvement of tax disclosures

12. Although there are a number of issues that arise in practice when applying IAS 12, our outreach suggests that users do not seem to be very concerned about addressing those issues. This does not mean that those issues are irrelevant to investment decisions made by users but that, because tax information is complex,

[3] If the Board considers a fundamental change in the main principle in IAS 12, it could, at the same time, consider scope issues (paragraphs 50-53).

users are unable to understand whether a particular tax issue is important to their investment decision. Therefore, one step that the Board could consider taking is improving the tax disclosures to make them more understandable.

Option 4: Development of educational materials

13. The Board could undertake a project to develop educational materials to assist with the application of IAS 12 in relation to specific issues. This option would be helpful in some cases, for example, when the Board wants to address concerns raised in relation to the difficulty users identified in assessing the recoverability of a deferred tax asset.

Option 5: Do no further work

14. The Board could decide to do no additional work on accounting for income taxes. This would allow the Interpretations Committee to continue to deal with practical income taxes issues, provide guidance where possible, and refer to the Board only issues that are difficult to address within the confines of the existing IFRS Standard.

History of the Board's work on Income Taxes

Before 2002

15. The first IAS 12 *Accounting for Taxes on Income* was approved by the IASC in 1979. In 1989, the IASC published an Exposure Draft E33 *Accounting for Taxes on Income*. However, the IASC delayed consideration of the comments on E33 until December 1992 because income taxes accounting developments were taking place in a number of countries. Ultimately, the IASC published Exposure Draft E49 *Income Taxes* in June 1994, which led to the existing Standard IAS 12 *Income Taxes* being issued in October 1996.

16. In April 2001, the newly established Board adopted those International Accounting Standards that were still in effect, including IAS 12.

2002—2011

17. In September 2002, the Board and the United States Financial Accounting Standards Board (FASB) agreed to work together, in consultation with other national and regional bodies, to remove the differences between IFRS Standards, including IAS Standards, and US GAAP (the 'Norwalk Agreement'). Accounting for income taxes was later selected as one of a small number of focussed areas in which the two boards attempted to eliminate major differences through short term standard-setting projects.

18. In March 2009, the Board published an Exposure Draft of a proposed replacement for IAS 12 (the 2009 Exposure Draft). This publication aimed to converge IAS 12 with US GAAP (SFAS 109, since codified as topic 740) and solve some practical application issues. However, the FASB suspended its deliberations and did not issue an Exposure Draft to amend SFAS 109.

19. After considering the feedback received on its 2009 Exposure Draft, the Board decided not to replace IAS 12. Instead, the Board decided to develop limited amendments that would resolve problems arising in practice under IAS 12, without changing the fundamental approach, and without increasing divergence from US GAAP. The Board decided that the scope of the project would include the items included in Table 1—*Topics identified by the Board in March 2010*. The Board subsequently addressed some of those issues but did not address all of them because of the need to complete work on other, higher priority projects.

Table 1—Topics identified by the Board in March 2010

Topics	***Subsequent developments***
1. Uncertain tax positions, but only after the Board completes its work on possible revisions to IAS 37	In October 2015, the Interpretations Committee published a Draft IFRIC Interpretation, which would provide specific

Provisions, Contingent Liabilities and Contingent Assets.	guidance for how uncertainty should be reflected in the accounting for income taxes.[4]
2. Deferred tax on remeasurement of investment property at fair value.	*Deferred Tax: Recovery of Underlying Assets* (Amendment to IAS 12) was issued in December 2010, addressing this topic.
3. Implementation of the following proposals, which were broadly supported by respondents to the 2009 Exposure Draft:	
(a) introduction of an initial step to consider whether the recovery of an asset or settlement of a liability will affect taxable profit.	No further work performed because of other higher priority projects.
(b) recognition of a deferred tax asset in full and an offsetting valuation allowance to the extent necessary.	No further work performed because of other higher priority projects.
(c) guidance on assessing the need for a valuation allowance.	No further work performed because of other higher priority projects.
(d) guidance on the meaning of substantive enactment.	No further work performed because of other higher priority projects.
(e) allocation of current and deferred taxes within a group that files a	No further work performed because of other higher priority projects.

[4] The comment period for the Draft IFRIC Interpretation *Uncertainty over Income Tax Treatments* ended on 19 January 2016 and the staff are currently analysing the comment letters received. Further information is available on the project page at http://www.ifrs.org/Current-Projects/IASB-Projects/IAS-12-Measurement-income-tax-uncertain-tax-position/Pages/Home.aspx.

consolidated tax return.	
4. Explore the possibility of resolving an issue relating to the tax effect of dividends by entities such as real estate investment trusts and co-operative societies.	No further work performed because of other higher priority projects.

2011—Present

20. In 2011, the Board conducted its first Agenda Consultation and, as a result, added to its research programme a longer-term research project on income taxes. In its December 2012 Feedback Statement on that Agenda Consultation, the Board:

(a) Stated that accounting for income taxes was one of three topics:

> that, because of their nature and complexity, cover matters for which the IASB does not plan to issue a Discussion Paper or research document within the next three years;

(b) Encouraged other standard-setters to investigate income taxes topics on its behalf:

> we [would] allocate staff to these projects to ensure that the information being gathered is likely to benefit the IASB when it does take a more active role in the project;

(c) Noted that neither it nor FASB had succeeded:

> in developing a converged and simplified Standard on income taxes. A fundamental review of income tax accounting would be a significant project.

21. The European Financial Reporting Advisory Group (EFRAG), together with the UK's Financial Reporting Council, had already conducted a research project to seek feedback on whether future effort should be focussed on improving IAS 12 and retaining its basic principles or developing a new approach based on different principles.[5] They published a Discussion Paper in 2011 and a related Feedback Statement in 2013 (the 2013 EFRAG Feedback Statement). In their 2013 EFRAG Feedback Statement, they reported that:

    (a) Almost all respondents highlighted that IAS 12 has deficiencies on both a conceptual level and an application level. However, they thought that IAS 12 was not fundamentally flawed and was generally well-understood by preparers and users of financial statements. They commented that the best way forward would be to address the deficiencies in IAS 12 through limited amendments.

    (b) A number of respondents also highlighted, as a first step, the need for further work on understanding the needs of users of financial statements in order to develop a clearer view of the objectives of providing income tax information. A large majority of respondents considered that the primary focus should be on developing better, not necessarily more, disclosure.

    (c) Some respondents highlighted other areas in which IAS 12 could be improved, such as the scope of the Standard, recognition criteria for deferred tax assets and other specific application issues. Only a few respondents supported a fundamental change in the accounting for income tax; they generally supported the 'accruals approach' outlined in paragraph 10 of Appendix A (Agenda Paper 19B).

22. The Interpretations Committee has continued to receive many questions on the application of IAS 12. In fact, the topic of income taxes generated the third

[5] The German standard-setter was also involved in the project but did not sign off on the Discussion Paper.

highest volume of its submissions during 2012-2014, after IFRS 10 *Consolidated Financial Statements* and IAS 39 *Financial Instruments*.

23. The Interpretations Committee has been responding to those IAS 12 questions. For example, it:

(a) recommended that the Board should amend IAS 12 to clarify how to account for deferred tax assets related to debt instruments measured at fair value. As a result, the Board issued, in January 2016, *Recognition of Deferred Tax Assets for Unrealised Losses* (Amendments to IAS 12);

(b) published a draft IFRIC Interpretation *Uncertainty over Income Tax Treatments* in October 2015; and

(c) published a number of Agenda Decisions that included technical explanations to assist consistent application.

24. However, there have also been cases where the Interpretations Committee has not clarified the accounting treatment but recommended that the Board should consider it in its research project on income taxes. For example, the Interpretations Committee discussed corporate wrappers (see Example 5 preceding paragraph 45) and, in July 2014, said:

> The Interpretations Committee noted that several concerns were raised with respect to the current requirements in IAS 12. However, analysing and assessing these concerns would require a broader project than the Interpretations Committee could perform on behalf of the IASB.
>
> Consequently, the Interpretations Committee decided not to take the issue onto its agenda but instead to recommend to the IASB that it should analyse and assess these concerns in its research project on Income Taxes.

Summary of principles in IAS 12

25. The current version of IAS 12 bases its income tax accounting principle on the balance sheet liability approach.[6] This approach is also used in US GAAP and a number of accounting standards in other countries. In this section, the staff explain the balance sheet liability approach with an illustrative example (see Example 1 following paragraph 30). Example 1 compares an entity that has a temporary difference with another entity that does not.

26. The principle underlying the balance sheet liability approach is that an entity should recognise a deferred tax liability (deferred tax asset) if recovery of the entity's assets and settlement of its liabilities at their carrying amount will increase (decrease) future payments of income taxes.

27. Said differently, the deferred tax liability (asset) is an accrual, today, of the income taxes that the entity expects to pay (receive) in the future, if it recovers its assets, and settles its liabilities, at their respective carrying amounts.

28. The reasoning underlying the balance sheet liability approach is as follows:

    (a) If an entity recognises an asset, the entity is implicitly asserting that it expects to recover at least the carrying amount of that asset. If the entity does not expect to recover that carrying amount, it would generally need to recognise an impairment loss. The deferred tax liability (or deferred tax asset) reflects the additional income taxes that the entity expects to pay (or receive) when it recovers that carrying amount.

    (b) Similarly, if an entity recognises a liability, the entity is implicitly asserting that it expects to settle that liability by paying no more than its carrying amount (together with any interest that will have accrued on that liability). If the entity expects to settle the liability for more

[6] Prior to issuing IAS 12 in October 1996, the IASC also considered other approaches, which the staff explain in Appendix A (Agenda Paper 19B).

than that amount, the carrying amount would generally need to be increased. The deferred tax liability (or deferred tax asset) reflects the additional income taxes that the entity expects to pay (or receive) when it settles the liability for its carrying amount.

29. Before October 1996, IAS 12 required an income statement liability approach. The balance sheet liability and income statement liability approaches have similar results in many respects. For example, under both methods, deferred tax assets and liabilities are:

(a) measured at the rate of tax expected to apply when the underlying asset is recovered or the underlying liability is settled; and

(b) adjusted for changes in the tax rate and for the imposition of new taxes.

30. However, in some circumstances, the differences between the two approaches can be significant. Whereas the balance sheet liability approach recognises deferred tax for temporary differences, the income statement liability approach recognises deferred tax for timing differences. All timing differences are temporary differences but some temporary differences are not timing differences. Examples of the latter include temporary differences that arise when:

(a) long-term assets are not deductible in determining taxable profit;

(b) assets and liabilities are acquired in a business combination; and

(c) goodwill is not amortised for tax purposes.

Example 1–Comparison of an entity with a temporary difference and an entity without a temporary difference

Entity A and Entity B acquired identical assets and liabilities at the beginning of 20X4. Their balance sheets at the beginning of 20X4 are as follows (before considering deferred tax):

	Entity A	**Entity B**
	CU	**CU**[7]
Cash	100	100
Equipment	200	200
	300	**300**
Liability	100	100
Equity	200	200
	300	**300**

For accounting purpose, both Entity A and Entity B depreciate the equipment over 2 years on a straight line basis.

Entity A fully depreciated the equipment for tax purposes in 20X4 and, therefore, at the end of 20X4, the tax base of the equipment for Entity A is nil. As a result, at the end of 20X4, Entity A has a temporary difference of CU100 (100-0) related to the equipment, for which a deferred tax liability is recognised.

On the other hand, the tax base of the equipment for Entity B is CU100 because Entity B claims a tax deduction for depreciation of the equipment over 2 years on a straight-line basis, which is the same as for accounting purpose. Therefore, Entity B has no temporary difference and no deferred tax liability is recognised.

The tax rate in the jurisdictions where Entity A and Entity B are resident is 40%.

The balance sheets at the end of 20X4 and the income statements for 20X4 and 20X5 using the balance sheet liability method, after the recognition of deferred income taxes, are as follow (assume Entity A and Entity B earn revenue of CU100 every year and there is no expense other than depreciation):

[7] In this agenda paper, currency amounts are denominated in 'currency units' (CU), unless otherwise stated.

Balance Sheets at the end of 20X4

	Entity A	**Entity B**
	CU	**CU**
Cash	100	100
Equipment	100	100
	200	**200**
Liability	100	100
Current tax liability (asset)	(40)	-
Deferred tax liability	40	-
Equity	100	100
	200	**200**

Income Statements for the year ended 20X4

	Entity A	**Entity B**
	CU	**CU**
Revenue	100	100
Depreciation	(100)	(100)
Profit (loss) before income taxes	-	-
Current tax expense (income)	(40)	-
Deferred tax expense (income)	40	-
Net profit (loss)	-	-

Income Statements for the year ended 20X5

	Entity A	Entity B
	CU	**CU**
Revenue	100	100
Depreciation	(100)	(100)
Profit (loss) before income taxes	-	-
Current tax expense (income)	40	-
Deferred tax expense (income)	(40)	-
Net profit (loss)	-	-

Application of deferred tax accounting

Entity A used accelerated depreciation for tax purpose. This reduced the current tax payable in 20X4 by CU40 and led to current tax income of CU40. However, because the carrying amount of the equipment was higher than its tax base, there would be an additional tax payment of CU40 in subsequent periods. Under the balance sheet liability method, a deferred tax liability of CU40 was recognised on Entity A's balance sheet at the end of 20X4 together with the deferred tax expense of CU40 in 20X4. As a result, Entity A's total tax expense in 20X4 is zero (current tax income of CU40 + deferred tax expense of CU40 = zero).

In 20X5, Entity A recognised accounting depreciation of CU100 but was unable to deduct it from taxable profit because the equipment was fully depreciated for tax purposes in 20X4. As a result, Entity A recognised a current tax expense and current tax liability of CU40. It also recognised deferred tax income of CU40 because the temporary difference had fully reversed and the deferred tax liability no longer existed. Thus, Entity A's total tax expense in 20X5 is zero (current tax expense of CU40 – deferred tax income of CU40 = zero).

On the other hand, Entity B claimed tax depreciation in the same amount as the accounting depreciation, reported profit before income taxes of zero and, as a result, had no current tax and deferred tax liabilities at the end of 20X4.

As the above example shows, the timings for tax deduction are different but the deferred tax accounting under the balance sheet liability method made Entity A's total tax expense the same as Entity B's total tax expense in each year by requiring Entity A to accrue as a (deferred) tax liability at the end of 20X4 the additional tax that Entity A will make in 20X5 as it recovers the carrying amount of the equipment.

Main application issues

31. The staff looked at tax issues referred to the Interpretations Committee, as well as the income tax topics that the Board discussed in the convergence project in 2009 and 2010 (see paragraphs 18-19). The staff have summarised in this paper those issues that are unresolved and seem to have a material impact on the financial statements. The staff think that those issues were unresolved either because they were expected to be resolved in the Board's convergence project on income taxes (which was never finished), or because the Interpretations Committee asked the Board to consider them in the current research project.

32. The following is a list of main application issues that have not been addressed by either the Board or the Interpretations Committee. The staff classified these issues into three types based on the cause of the issue:

(a) **Type One**: as noted in paragraph 8(a), some people think that these issues involve a mismatch between recognition of tax expense (income) and recognition of related income (expense). The specific issues identified here relate to:

(i) intercompany transfer of assets;

(ii) tax base denominated in a currency which is not the functional currency; and

(iii) tax effect of share-based payment.

(b) **Type Two**: issues that arise because, in the view of some people, IAS 12 does not fit well with more recent IFRS Standards or more recent tax laws across the world. The specific issues identified here related to:

(i) fair value measurement (including corporate wrapper);

(ii) tax effect of dividends; and

(iii) issues relating to the scope of income tax accounting.

(c) **Type Three**: issues that arise because incomes taxes are complex and tax disclosures lack transparency. The specific issues identified here related to:

(i) tax disclosures;

(ii) discounting current tax and deferred tax; and

(iii) other issues including intra-period tax allocation and interim financial statements.

Type One: issues that arise because of perceived accounting mismatches

Intercompany transfer of assets

33. When inventory is sold between jurisdictions within the same consolidation group, the carrying amount in the consolidated financial statements does not change because any gain or loss on the sale is eliminated, until the inventory is sold outside the group. However, if the transfer price is different from (usually it exceeds) the cost of the inventory, this has the following consequences (see Example 2, which follows paragraph 35):

   (a) current tax expense arises in the selling entity ('seller') on the gain, at the tax rate applicable in the seller's tax jurisdiction;

   (b) the tax base in the receiving entity ('buyer') is the transfer price rather than the original cost to the consolidation group. In the buyer's individual financial statements, the carrying amount is the same as the tax base (ie transfer price) and hence no deferred tax asset or deferred tax liability arises;

   (c) on consolidation, the tax base of the inventory (in the buyer's tax jurisdiction) is still the transfer price but the (consolidated) carrying amount is the original cost to the group. This creates a deductible temporary difference and hence a deferred tax asset, (assuming the transfer price is above cost) and deferred tax income arise, both at the tax rate applicable in the buyer's tax jurisdiction. If the tax rates in the buyer's and seller's tax jurisdictions are identical, there is no overall effect on profit or loss. However, if the rates differ, there is a net effect, caused by the difference between the two rates;

   (d) when the buyer ultimately sells the inventory, it will pay tax on the difference between the selling price and the transfer price, at the rate applicable in the buyer's tax jurisdiction.

34. However, some people are not convinced of the merits of measuring the deferred tax asset at the buyer's tax rate. For example, the staff often heard in the Global Preparers Forum (GPF) that some members asked the Board to consider

measuring the deferred tax asset for the intercompany asset transfer at the seller's tax rate rather than the buyer's tax rate. A number of respondents to the 2009 Exposure Draft, mainly multinational companies and their representative bodies in Europe, USA and Japan, commented that measuring the deferred tax at the buyer's rate (rather than the seller's rate) distorts financial performance and causes volatility in the effective tax rate. The same comment was also made from one respondent to the 2015 Agenda Consultation (see paragraph 10(b) of Appendix D: Income Taxes feedback from the 2015 Agenda Consultation (Agenda Paper 19E)).

35. Using US GAAP, the current tax expense in the seller's jurisdiction is deferred and no deferred tax in the buyer's jurisdiction is recognised until the related income is recognised in the consolidated income statement. Thus, the current tax liability and the deferred tax asset are both measured at the seller's tax rate.[8]

[8] FASB ASC Topic 740-10-25-3(e) and Topic 810-10-45-8. The FASB issued an Exposure Draft in January 2015 in their simplification initiative and proposed to eliminate the exception in US GAAP for the issue relating to the intercompany transfer of an asset. After analysing the comments received, the FASB has instructed the staff to perform additional outreach on intra-entity asset transfers.

Example 2–Intercompany transfer of assets

Company B is a wholly owned subsidiary of Company A. In 20X4, Company B purchased goods from Company A for CU100. The cost of the goods to Company A was CU80. The goods were ultimately sold to third parties in 20X5 for CU140.

Company A is resident in Country A and is subject to a 30% corporate tax rate; Company B is resident in Country B and is subject to a 35% corporate tax rate.

For 20X4, Company A computed its taxable profit of CU20 (100-80=20) and recognised a current tax liability of CU6 (20x30%=6). At the end of 20X4, in the consolidated financial statements, a deductible temporary difference of CU20 (80-100=20) arose and so the entity recognised a deferred tax asset of CU7 (20x35%=7).

For 20X5, Company B computed its taxable profit of CU40 (140 -100=40) and recognised a current tax liability of CU14 (40x35%=14). At the end of 20X5, no temporary difference existed and so it recognised a deferred tax expense of CU7.

The balance sheets at the end of 20X4 are as follow:

	Company A	**Company B**	**Consolidated**
	CU	**CU**	**CU**
Cash	300	100	400
Inventory	0	100	80
Deferred tax asset	-	-	7
	300	**200**	**487**
Liability	100	100	200
Current tax liability	6	-	6
Equity	194	100	281
	300	**200**	**487**

The consolidated income statements for 20X4 and 20X5 are as follow:

	20X4	**20X5**
	CU	**CU**
Revenue	-	140
Expense	-	(80)
Profit (loss) before income taxes	-	60
Current tax expense	(6)	(14)
Deferred tax income (expense)	7	(7)
Net profit (loss)	1	39

This accounting model produces an understandable result in the balance sheet. If the entity recovers the carrying amount of the inventory of CU80 (in the consolidated financial statements), it will pay CU7 less tax than it would pay if the tax base were same as the carrying amount (that is normally the case, if Company B purchased the inventory from a third party).

However, some people think the above accounting model produces counterintuitive results in the income statement. This is because, in 20X4, inventory was moved to a higher tax jurisdiction. Intuitively, a reader of the financial statements may expect a higher tax expense will arise in 20X4 than if the entity had kept the inventory in the lower low tax jurisdiction. However, this accounting model actually produces a lower tax expense (or a net tax gain) in 20X4.

Tax base denominated in a currency that is not the functional currency

36. Assume that an entity has a functional currency that differs from its local currency and that the tax base is determined in the local currency. The equivalent amount of the tax base in the functional currency changes as the exchange rate changes. This gives rise to a temporary difference, even though the carrying amount of the underlying asset does not change in the functional currency and, therefore, no income or expense is recognised in the income statement. Nevertheless, there is an economic loss (or gain) in the functional currency, resulting from the change in the functional currency equivalent of the tax base. A deferred tax liability (or asset) is recognised to depict that economic loss (or gain).[9] However, some people are not convinced of the merits of recognising that deferred tax liability (or asset) and would prefer an exception similar to one provided in US GAAP.[10]

[9] One way to express this is as follows: The tax base will provide tax benefits that are denominated in the local currency. In effect, the tax base is a monetary asset, denominated in local currency. This creates a foreign exchange exposure against the functional currency. The deferred tax reflects that exposure.

[10] ASC topic 740-10-25-3(f) prohibits recognition of a deferred tax liability or asset for differences related to assets and liabilities that are remeasured from the local currency into the functional currency using historical exchange rates and that result from changes in exchange rates or from indexing for tax purposes.

37. For example, the Interpretations Committee received a submission on this issue in September 2015.[11] Also, in the 2015 Agenda Consultation, one comment letter and six online survey responses referred to this issue. All seven responses were from South American countries, including five preparers and one user of financial statements. One respondent commented that the recognition of deferred tax in such cases is inconsistent with the *Conceptual Framework*. Other respondents commented that the volatility in deferred tax may not necessarily reflect a true and fair result of their business (see paragraph 10(a) and paragraph 19(iv) of Appendix D: Income Taxes feedback from the 2015 Agenda Consultation (Agenda Paper 19E)).

[11] The Interpretations Committee decided to decline the request contained in the submission and the decision was presented to the Board in February 2016.

Example 3—Tax base denominated in a currency that is not the functional currency

Company A is located in Country L where taxable profit is determined in local currency (LC) and the tax rate is 30%.

In applying IAS 21 *The Effects of Changes in Foreign Exchange Rates*, Company A determined its functional currency as FC.

Company A purchased a machine for LC100 on 1 January 20X4. At that time, the exchange rate between LC and FC was 1:1. Thus, the machine's carrying amount was FC100.

The depreciation expense per year is FC20 for accounting purposes and LC20 for tax purposes.

Immediately after the purchase of the machine, the exchange rate between LC and FC changed to 1:0.7 and that exchange rate continued until the end of 20X8. This change created a temporary difference between the carrying amount of the machine (in FC) and the FC equivalent of the tax base. A deferred tax liability was recognised for that temporary difference.

Balance sheets as at the end of 20X4 to 20X8:

	20X4	**20X5**	**20X6**	**20X7**	**20X8**
	FC	**FC**	**FC**	**FC**	**FC**
Cash	100	110	120	130	160
Machine	80	60	40	20	-
	180	170	160	150	160
Liability	100	70.8	41.6	12.4	3.2
Current tax liability	10.8	10.8	10.8	10.8	10.8
Deferred tax liability	7.2*	5.4*	3.6*	1.8*	-*
Equity	62	83	104	125	146
	180	170	160	150	160

* In 20X4, the tax base was FC56 (LC80*0.7), the taxable temporary difference was FC24 (80-56=24) and thus the deferred tax liability was FC7.2 (24*30%=7.2). Similar calculations are made for the other years.

The income statements for 20X4 to 20X8 are as follows:
(assume revenue is 50 every year and there is no expense other than depreciation).

	20X4	20X5	20X6	20X7	20X8
	FC	**FC**	**FC**	**FC**	**FC**
Revenue	50	50	50	50	50
Depreciation	(20)	(20)	(20)	(20)	(20)
Profit (loss) before income taxes	30	30	30	30	30
Current tax expense*	(10.8)	(10.8)	(10.8)	(10.8)	(10.8)
Deferred tax income (expense)	(7.2)	1.8	1.8	1.8	1.8
Net profit (loss)	**12**	**21**	**21**	**21**	**21**
Effective tax rate	60%	30%	30%	30%	30%

*Current tax expense for 20X4 through 20X8: (Revenue LC71.4 (FC50/0.7) – depreciation LC20)*30%*0.7= FC10.8

If the exchange rate had not changed and had continued to be 1:1 throughout the periods, the income statements would have been as follows:

	20X4	20X5	20X6	20X7	20X8
	FC	**FC**	**FC**	**FC**	**FC**
Revenue	50	50	50	50	50
Depreciation	(20)	(20)	(20)	(20)	(20)
Profit (loss) before income taxes	30	30	30	30	30
Current tax expense*	(9)	(9)	(9)	(9)	(9)
Net profit (loss)	**21**	**21**	**21**	**21**	**21**
Effective tax rate	30%	30%	30%	30%	30%

*Current tax expense for 20X4 through 20X8: (Revenue LC50 (FC50/1.0) – depreciation LC20)*30%*1.0= 9.

Because of the change in the exchange rate in 20X4, Company A's ability to claim tax depreciation in terms of FC was reduced. As a result, Company A's current tax expense increased from FC9 to FC10.8 every year. The deferred tax liability of FC7.2 was recognised in 20X4 in order to reflect the increase in current tax expense from 20X4 through 20X8.

However, some argue from the income statement point of view, that the deferred tax expense recognised in 20X4 just created volatility in profit or loss, while the actual cash tax payments are consistently at the (higher) amount of FC10.8 throughout the periods.

Tax effect of share-based payment

38. In some tax jurisdictions, an entity receives a tax deduction for remuneration (employee service expense) paid in shares, share options or other equity instruments of the entity. The amount of that tax deduction may differ from the related cumulative remuneration expense and may arise in a different (often later) period. For example, in some jurisdictions, an entity recognises an expense for the consumption of employee services received as consideration for share options granted, in accordance with IFRS 2 *Share-based Payment*, and may not receive a tax deduction until the share options are exercised. In this scenario, the measurement of the tax deduction is often based on the entity's share price at the date of the exercise.

39. Using IAS 12, the tax base of the employee services received to date is estimated, based on the available information at the end of each reporting period. For example, if the tax deduction is determined by the entity's share price at the date of the exercise, the future tax deduction is estimated based on the entity's share price at the end of the reporting date. Because related employee services are recognised in profit or loss and nothing is recognised in the balance sheet, the carrying amount of the employee services is nil. As a result, a deductible temporary difference arises in the same amount as the tax base of the employee services and an entity recognises a deferred tax asset for that temporary difference. That deferred tax asset is reassessed every year until the share-based payment is exercised. On exercise, the deferred tax asset is reversed (giving rise to deferred tax expense) and current tax income is recognised to reflect the tax deduction actually claimed in that period. If the amount of the tax deduction exceeds the cumulative amount of the remuneration expense, part of the tax deduction is considered to relate to that remuneration expense and the excess is considered to relate to an equity item. In that situation, the tax effect of the excess is recognised directly in equity.

40. Under US GAAP (before an ASC Update in March 2016), deferred tax was recognised only to the extent of the employee service expense. The tax effect of the excess tax deduction (ie windfall) or deficiency was recognised in current tax

only when it is realised through a reduction in current tax expense. The tax effect of the windfall was recognised in additional paid in capital and the tax effect of any deficiency was recognised in profit or loss after offsetting the cumulative windfall in additional paid in capital.

41. In the comment letters on the 2009 Exposure Draft, some respondents preferred the US GAAP treatment over the IFRS Standards treatment and asked the Board to change the IFRS treatment. However, as part of its simplification project, the FASB issued, on 31 March 2016, an Accounting Standard Update No.2016-09 Compensation—Stock Compensation (Topic 718): *Improvements to Employee Share-based Payments Accounting*. This document requires entities to recognise:

    (a) the excess tax benefit, regardless of whether the benefit reduced taxes payable in the current period (the same as IAS 12); and

    (b) the tax effect of windfalls or deficiencies in profit or loss rather than in additional paid in capital (different from IAS 12).

42. The staff is not certain whether those respondents who commented on the 2009 Exposure Draft still preferred the previous US GAAP treatment over the IFRS treatment.

Type Two—issues that arise because some believe IAS 12 may not fit well with recent standards or recent tax laws

Issues relating to fair value measurement (including corporate wrapper)

43. In some situations, a temporary difference arises when an entity initially acquires an asset. This is the case, for example, when:

    (a) an entity acquires a building but the tax law does not allow any tax deduction for depreciation of the building (see Example 4); or

    (b) an entity acquired a company (corporate wrapper) whose only asset is a building, which has already been depreciated within the corporate wrapper for tax purposes, earlier than for accounting purposes (see Example 5).

44. In some jurisdictions, the amount of tax payable on recovering the carrying amount of an asset depends on the manner of recovery. For example, in some jurisdictions capital gains are exempt from tax or subject to a lower tax rate. Applying paragraph 51 of IAS 12, deferred tax reflects the expected manner of recovery. In December 2010, the Board issued *Deferred Tax: Recovery of Underlying Assets* (Amendment to IAS 12). The amendment addressed the expected manner of recovering the carrying amount of investment property. However, it did not address the recovery of other assets, such as property, plant and equipment (paragraph 43(a)) or assets held by a corporate wrapper (paragraph 43(b)). The former issue exists only in a limited number of jurisdictions. However, the latter issue was raised by international accounting firms and is more widespread. In response to a submission in 2011, the Interpretations Committee staff conducted outreach and commented that the corporate wrapper issue was pervasive in Europe and emerging in China.[12] Those issues are generally raised in the context of the expected manner of recovery in paragraph 51 of IAS 12. However, the staff think that those issues also contain more difficult issues such as fair value and tax effect, which are reflected in the following examples.

[12] http://www.ifrs.org/Meetings/Documents/IFRICSep11/131109AP13IAS12corporatewrapper.pdf

Example 4—Depreciation is non-deductible for tax purpose

Assume a building is located in Country A where depreciation is not deductible for tax purposes. The tax rate in Company A's jurisdiction is 28%. The fair value of the building is computed as follows in 20X5 (Year 1):

	Year 1	Year 2	Year 3	…	Year 49	Year 50
	CU	CU	CU		CU	CU
Rental income	5,000	5,000	5,050	…	6,000	6,000
Admin expense	(400)	(400)	(404)	…	(500)	(500)
Depreciation –tax deduction	0	0	0	…	0	0
Income taxes (28%)[13]	(1,288)	(1,288)	(1,301)	…	(1,540)	(1,540)
Net cash inflow	3,312	3,312	3,345	…	3,960	3,960
NPV@5%	**66,000**			…		

Case 1) Initial acquisition

Assume Company A purchases this building for its own use in 20X5 for its fair value of CU66,000. The entity recognised the building at CU66,000 and does not recognise any deferred tax liability (paragraph 15 of IAS 12).[14]

Case 2) Subsequent Revaluation

Assume Company B purchased the building in 20X4 for CU50,000 (ie fair value at the time of the purchase in 20X4) and chose to use the revaluation method in paragraph 31 of IAS16 *Property, Plant and Equipment*. It revalues the building to CU66,000 in 20X5. A deferred tax liability is not recognised for the initial temporary difference of CU50,000 but is recognised for a subsequent remeasurement gain of CU16,000 (66,000-50,000=16,000. 16,000*28%=CU4,480**)** (paragraph 20(a) of IAS12).

[13] According to the result of our outreach to a valuation specialist, generally a value of a business asset is computed taking into consideration its tax effect.

[14] If US GAAP were applied, Topic 740-10-25-51 requires that the simultaneous equation method is used and the carrying amount of an asset is grossed up to 91,667 with a deferred tax liability of 25,667 for the initial temporary difference of 66,000 (91,667-25,667=66,000)

Case 3) Business Combination

Assume Company C purchases the same building in 20X5 in a business combination. The building is recognised at CU66,000 (paragraph 18 of IFRS 3) and a deferred tax liability is recognised for the entire temporary difference of CU66,000 (paragraph 24 of IFRS 3, paragraph 66 of IAS12). This also increases the carrying amount of goodwill by the same amount (66,000*28%=CU18,480).

The balance sheets at the end of 20X5 are as follows:

	Case 1	**Case 2**	**Case 3**
	CU	**CU**	**CU**
Cash	10,000	10,000	10,000
Building	66,000	66,000	66,000
Goodwill	-	-	18,480
	76,000	**76,000**	**94,480**
Liability	10,000	10,000	10,000
Deferred tax liability	-	4,480	18,480
Equity	66,000	61,520	66,000
	76,000	**76,000**	**94,480**

In the above example, several questions arose, such as:

(a) Is the economic substance of the building held by Company A different from that of Company B or Company C?

(b) Companies A, B and C own the same building, which has the same amount of temporary difference. However, only Company B and Company C recognise deferred tax liabilities and the amounts recognised by Company B and Company C are different. Why?

(c) Some people say that the tax effect of disallowing the building's depreciation has already been reflected in the fair value of the building; therefore, recognising a separate deferred tax liability would double-count the same tax effect. Is this right?

(d) Is the goodwill arising from the business combination in Case 3 overstated?

Example 5—Corporate Wrapper

In the jurisdiction where Building X is located, annual depreciation deductible for tax purposes is equal to 10% of cost and taxable profit is subject to income taxes at 28%. However, any gain from selling shares in a company is taxed at 0%.

Properties are usually traded through selling and buying shares in a company whose only asset is the property (corporate wrapper). Estimates of fair value typically assume that any disposal will be of the corporate wrapper by the owner, and will not involve a disposal of the building by the corporate wrapper itself. Thus, the only tax payable within the corporate wrapper will arise on the rental income less depreciation.

Company A purchases, for CU74,475, Company B, which owns a single asset, Building X, at the beginning of Year 1. The tax base of Building X at that date was CU67,779, which was the original cost (CU75,310) less accumulated depreciation to date (CU7,531).

	Year 1	**Year 2**	**Year 3**	**…**	**Year 49**	**Year 50**
	CU	**CU**	**CU**		**CU**	**CU**
Income	5,000	5,000	5,050	…	6,000	6,000
Expense	(400)	(400)	(404)	…	(500)	(500)
Depreciation - tax deduction	(7,531)	(7,531)	(7,531)	…	0	0
Income taxes (28%)	0	0	0	…	(1,540)	(1,540)
Net cash inflow	4,600	4,600	4,646	…	3,960	3,960
NPV@5%	**74,475**					

At the end of Year 2, due to increased expected cash inflow, Company Y revalued Building X to 79,222.

	Year 3	**Year 4**	**…**	**Year 49**	**Year 50**
	CU	**CU**	**CU**	**CU**	**CU**
Income	5,800	5,800	…	6000	6,000
Expense	(440)	(440)	…	(500)	(500)
Depreciation tax deduction	(7,531)	(7,531)	…	0	0
Income taxes (28%)	0	0	…	(1,540)	(1,540)
Net cash inflow	5,360	5,360	…	3,960	3,960
NPV@5%	**79,222**				

Case 1—Subsequent fair value remeasurement

At the end of Year 2, Company A has the following temporary difference and recognises the following deferred tax liability:

	Inside Basis (a difference between the tax base of Building X—in Company B's jurisdiction—and its carrying amount)	Outside Basis (a difference between the tax base of shares in Company B —in Company A's jurisdiction—and their carrying amount)
Temporary difference	(79,222 – 52,717) =CU26,505	(83,110 –74,475) = CU8,635
Initial difference	CU7,531	-
Deferred tax liability recognised	(26,505-7,531)*28% = CU5,312	8,635*0% = CU0

Tax base of the building: 67,779-(7,531*2)=CU52,717

Carrying amount of the building (at fair value) = CU79,222

Tax base of the shares in Company B: CU74,475

Carrying amount of the shares in Company B (assume no dividends were paid out by the company): the carrying amount of the building + cash received after initial acquisition – deferred tax liability provided after initial acquisition = 79,222+4,600+4,600-5,312 = CU83,110

Case 2—Initial recognition

Assume Company C initially purchases Company B at the end of Year 2 and the purchase is considered not to be a business combination. No deferred tax will be recognised for the initial temporary difference: (paragraph 15 of IAS 12)

	Inside Basis	Outside Basis
Temporary difference	26,505	-(*)
Initial difference	26,505	-
Deferred tax liability	-	-

* The carrying amount of the shares in Company B = its tax base = CU79,222

Case 3—Business Combination

If the purchase in Case 2 is considered a business combination, the following deferred tax liability is to be recognised with an opposite entry to goodwill:

	Inside Basis	Outside Basis
Temporary difference	26,505	-
Initial difference	-	-
Deferred tax liability and goodwill	26,505*28% = 7,421	-

In the above example, several questions arose, such as:

a) Is the economic substance of Building X held by Company B different at the end of Year 2, depending on whether:

(i) it is initially acquired in an asset acquisition (Case 2);

(ii) it is subsequently re-measured to fair value (Case 1); or

(iii) it is initially acquired in a business combination (Case 3)?

b) Deferred tax liability is only recognised in Cases 1 and 3 and the amounts recognised are different. Why?

c) Some people say that the non-deductibility of the difference between the carrying amount and the tax base of Building X has already been taken into consideration in the fair value assessment process and the separate recognition of a deferred tax liability has double counted the tax effect. Is this right?

d) Is the goodwill arising from the business combination in Case 3 overstated?

45. According to a background document published by the IASC with Exposure Draft E49 in 1995, the IASC created the initial recognition exception in paragraph 15 of IAS12 because it thought that consideration paid for a long-term asset implicitly took account of the non-deductibility of the asset for tax purposes. If this is correct, a similar situation also arises in the subsequent remeasurement of a long-term asset at fair value. However, the IASC did not create another exception for the case of subsequent fair value measurement. The staff think that this may be because subsequent fair value measurement was not so common in 1996. For

example, IAS 40 *Investment Property*, which permits an entity to choose the fair value measurement of investment property, was issued only in April 2000.

Tax effect of dividends

46. In some jurisdictions, income taxes are payable at a higher or lower tax rate if part of the net profit, or retained earnings, is paid out as a dividend to shareholders of the entity. IAS 12 was amended in 2000 to deal with this situation. It requires an entity to measure a tax asset or tax liability using the tax rate(s) that apply for undistributed profit, until the point when the entity recognises the distribution.

47. The amendment in 2000 was introduced in response to a question from a country where undistributed profit was taxed at a higher tax rate than distributed profit. However, since then, we have been informed that dividend taxation is now used in various situations in various ways. For example, in some countries, certain investment entities are granted a de-facto tax exempt status if they distribute all or most of their profit as dividends because those entities are entitled to a tax deduction for dividends paid. Those entities have a policy to pay out all, or most, profit to investors as a dividend and, therefore, they pay almost no income taxes throughout their corporate life. However, IAS 12 requires those entities to recognise current tax payable if dividends have not yet been declared and subsequently reverse that tax entirely when the dividends are declared. If those entities have a temporary difference, IAS 12 also requires them to recognise a deferred tax liability for temporary differences at a tax rate applied to undistributed profit, even though they have a policy to pay out all profit as a dividend.

Example 6—tax effect of dividend when a dividend is deducted from taxable profit when it is paid

Company A is an investment vehicle through which investors invest their money in the underlying properties. In Company A's jurisdiction, Company A is granted a de-facto tax exempt status where Company A is entitled to a tax deduction for dividends paid within six months after the end of the reporting period. The tax rate in Company A's jurisdiction is 30% and Company A can pay a dividend only when it has closed the annual accounts after the end of the reporting period.

In 20X4, Company A earned profit before income taxes of CU400. Company A has a policy to pay out all profits for the year as a dividend. Therefore, for 20X4, it expects to pay a dividend of CU400 before 30 June 20X5 and, as a result, pay no income taxes on the profit for 20X4.

However, paragraph 52B of IAS 12 requires that the income tax consequences of dividends are recognised when a liability to pay the dividend is recognised. Company A recognises a liability to pay a dividend only after the close of the annual accounts for 20X4. Therefore, Company A has to recognise a current tax liability of CU120 (400*30%) in its financial statements for the year 20X4.

Assume there is a taxable temporary difference of 100 related to the underlying properties of Company A. Paragraph 52A requires that current and deferred tax assets and liabilities are measured at the tax rate applicable to undistributed profit. Although Company A has a de-facto tax exempt status and has no expectation to pay tax in the future, it must also recognise a deferred tax liability of CU30 (100*30%) at the end of 20X4.

Company A's income statement and balance sheet for 20X4 and 20X5 are as follow (assuming Company A has no revenue and expense in 20X5):

	20X4	**20X5**
	CU	**CU**
Profit before tax	400	-
Current tax expense (income)	120	(120)
Deferred tax expense (income)	30	(30)
Profit (or loss) after income taxes	250	150

Some think that the above accounting result does not reflect the economic reality of Company A. This is because, although Company A does not expect to pay tax at all throughout its corporate life, its financial statements shows a tax expense and tax liability in 20X4 which are completely reversed without actual cash tax payment in 20X5.

48. In the 2009 Exposure Draft, the Board proposed that an entity should measure current and deferred tax assets and liabilities at a tax rate that reflected the entity's expectation of future dividend payments. That proposal would have addressed the issue related to the tax effect of dividends. A majority of respondents to the 2009 Exposure Draft supported that proposal. However, as noted previously, the Board did not finalise any amendments to IAS 12 on the basis of the 2009 Exposure Draft.

49. Further, the tax effect of dividend relates to the tax effect of investments in subsidiaries, branches and associates and joint arrangements because, in many cases, the carrying amount of those investments are recovered through receiving dividends from those investees.[15] If the Board considers the tax effect of dividends, it may also wish to revisit, for consistency, the exception for investments in subsidiaries, branches etc in paragraph 39 of IAS 12.

Scoping issue 1: Definition of income taxes

50. Sometimes it is unclear whether a particular tax is within the scope of IAS 12. For income taxes, an entity is required to recognise both current tax and deferred tax and is subject to various disclosure requirements in IAS 12. However, if a tax is not an income tax:

    (a) there is no explicit requirement to recognise deferred tax;

    (b) when there is uncertainty in the amount, or timing, of the tax payment, it is accounted for in accordance with IAS 37; and

    (c) the disclosure requirements of IAS 12 do not apply.

51. A tax is generally within the scope of IAS 12 if it is based on (net) profit or loss (or adjusted profit or loss) and is generally not within the scope of IAS 12 if it is based on revenue or other factors. However, the staff have been informed that it

[15] The Interpretations Committee received a request to clarify the term "branches" in paragraph 39 of IAS 12. The Interpretations Committee rejected the request because, at that time, the 2009 ED was expected to address that issue.

is difficult to determine whether, for example, the following types of tax are within the scope of IAS 12:

(a) Tax that is based on revenue less some expenses, rather than on net profit plus some added back expenses.

(b) A tax that is computed based on net profit, adding back net interest, salaries and depreciation, with the aim of being close to the amount subject value added tax.

(c) Tax that is computed on the basis of two or more systems, for example, the greater of the normal corporate income tax and a minimum tax based on a different amount and at a different tax rate. In some cases, an entity might have the right to elect whether it pays tax on net profit or on another basis.

Scoping issue 2: Deferred tax for own equity instruments

52. The basic principle in IAS 12 is to account today for the future tax effect of recovery (or settlement) of the carrying amount of an asset (or liability). However some own equity transactions (eg purchasing treasury stock) have tax effects in some jurisdictions. IAS 12 is silent on those tax effects.

Scoping issue 3: Accounting for investment tax credits etc

53. Government assistance in the form of benefits that are available in determining taxable profit or taxable loss, or are determined or limited on the basis of income tax liability (tax benefits) is excluded from the scope of IAS 20 *Government Grants and Disclosure of Government Assistance*. IAS 20 states that such benefits include income tax holidays, investment tax credits, accelerated depreciation allowances and reduced income tax rates. Furthermore, IAS 12 states that it does not deal with the method of accounting for government grants or investment tax credits. In the comment letters on the 2009 Exposure Draft, the staff were informed that there was diversity in practice in accounting for tax

benefits such as investment tax credit.[16] As a result, some respondents suggested that the Board should review IAS 20 and establish a principle to account for tax credits and investment tax credits, as well as other items, to include government grants, special deductions and tax holidays.

Type Three: Issues that arise because income taxes are complex and tax disclosures lack transparency

Tax disclosures

54. Some respondents to the 2009 Exposure Draft, including users of financial statements, suggested the following improvements in the presentation and disclosure of tax information:

    (a) Introduction of the concept of a valuation allowance (to offset against a deferred tax asset) and related disclosures.

    (b) Additional and more helpful guidance on assessing the recoverability of a deferred tax asset (or valuation allowance), particularly when an entity has a history of tax losses.

    (c) Improvement in disclosure of the tax effect of investment in subsidiaries in order for users to better understand the consequences of cash repatriation from subsidiaries and its impact on the effective tax rate.

    (d) Additional and more useful disclosures on uncertain tax positions, including roll-forward of unrecognised tax positions and significant increase/decrease of uncertain tax positions within the following 12 month period.

[16] The staff were told that that there were at least the following possible accounting treatments for investment tax credit: (1) a current tax only, with no impact on deferred taxes, (2) an adjustment to the deferred tax calculation, either by adjusting the tax base or changing the expected tax rate and (3) accounted for as government grants by reference to IAS 20.

55. The staff recently conducted an investor survey (see Appendix C: Investor Survey Questionnaire (Agenda Paper 19D)) and were told that users of financial statements use information about income taxes, including both deferred tax and current tax, in order to estimate future tax cash flows as well as to evaluate the entity's financial soundness. However, many users complain that the way the tax information is disclosed is unclear, lacks transparency and does not enable them to understand the whole picture of the entity's tax position. Some users believe that entities use it to manage earnings. Many users have asked us to improve the tax disclosures so that they can better understand an entity's tax strategy and assess the tax risks that may affect an entity's sustainability.

56. For example, in some jurisdictions, tax authorities provide agreements with entities to exempt a specified pool of income from taxation or subject the income to a lower tax rate. The impact of that kind of arrangements is generally disclosed in the notes to the financial statement under the tax rate reconciliation. However, in many cases, the impact is included in an item named 'foreign tax differences', and is not disclosed separately. Many investors think overly aggregated tax information is not helpful. They want to know what the main drivers of tax savings are, in which jurisdictions the entity is paying tax, what risks affect the entity's tax strategy and whether the entity's current tax strategy is sustainable. They consider that the current practice of tax disclosures under IAS 12 is too technical, too mathematical and does not provide the information that the users want to obtain (see Appendix B: Feedback from Investor Outreach for more detail (Agenda Paper 19C)).

57. The FASB, in its Disclosure Framework project, has recently reviewed the income tax disclosures in US GAAP and decided to propose some improvements in tax disclosures which include, but are not limited to;

   (a) A change in tax law that will affect the entity in the future.

   (b) Separate presentation of domestic income taxes and foreign income taxes.

   (c) Explanation of the provision and reversal of the valuation allowance.

(d) Improvements in the tax rate reconciliation.

(e) Improvements in the carryforward disclosure.

Discounting current and deferred tax

58. Discounting deferred tax would be a complex exercise. Many preparers think it is not practical to estimate the timing when temporary differences will reverse and when an unused tax loss and tax credit will be utilised. From a technical viewpoint, arguably some deferred taxes are already discounted (wholly or in part) when the underlying asset or liability is measured at the discounted value. So it is difficult to determine which deferred taxes should be discounted and which should not.

59. There are also some issues relating to the interaction of tax with discount rates. The staff have reviewed these issues in the research project on *Present value measurement—discount rates research* (see agenda papers 17-17B for the Board meeting in December 2015).

60. However, not discounting deferred tax can distort accounting results. For example, in a business combination, almost all assets and liabilities are measured at fair value, except for deferred tax assets and deferred tax liabilities. If deferred tax liabilities (assets) are not discounted, that typically results in overstating (understating) the amount of goodwill, because goodwill is measured as a residual. The impairment test for goodwill will not necessarily detect any overstatement.

61. Many investors believe that, theoretically, deferred tax should be discounted. However, they also agree that discounting deferred tax is a complex exercise and so they do not mind getting undiscounted numbers that they can feed into their valuation model.

Other issues

62. Staff were told by some constituents that requirements in IAS 12, in the following areas, were also complex and need improvement:

(a) Allocation of income tax expense in the same period between profit or loss, other comprehensive income (OCI) and equity (intra-period allocation).

(b) Presentation and disclosure of tax expense in the interim financial statements

Potential ways forward

63. As noted in paragraph 9, the staff have identified five possible ways forward to deal with the main application issues identified in paragraphs 31-62. These are discussed in more detail in the following paragraphs.

Option 1: Fundamental review of the main principles in IAS 12

64. The Board could decide to undertake a project to fundamentally reconsider the main principles used in IAS 12. For example, the Board could change from the balance sheet liability approach to another approach if it concluded that doing so would improve the relevance of financial information without incurring an undue cost burden on preparers (see Appendix A: Various Accounting Models for Income Taxes (Agenda Paper 19B)).

65. If the Board want to address the Type One issues identified previously, it may choose to undertake a project to completely rewrite IAS 12. In that case, the Board could also consider addressing Type Two issues (eg corporate wrapper) and Type Three issues (eg improvement in tax disclosures) at the same time.

66. A fundamental review of the main principles in IAS 12 would be a major project, taking a number of years and requiring considerable resources, with no guarantee that any new model would command widespread support. In accordance with the 2013 EFRAG Feedback Statement (see paragraph 21), many respondents did not support a fundamental change. This was because they did not think that IAS 12 was fundamentally flawed. On the contrary, they thought it was generally well understood by preparers and users of the financial statements. The results of the 2015 Agenda Consultation (see Appendix D: Income Taxes feedback from the

2015 Agenda Consultation (Agenda Paper 19E)) and our recent user survey (see Appendix B: Feedback from Investor Outreach (Agenda Paper 19C)) also indicate that there is not much support for this option. The staff think that if the Board would like to exercise this option, it would have to conduct further research and obtain new evidence to support a fundamental change.

Option 2: Narrow scope amendments to address some practice issues

67. The Board could undertake a series of narrow scope amendments to address some practice issues (mainly Type Two issues), for example:

    (a) to create an exception similar to the exception in paragraphs 15 and 24 of IAS 12 (initial recognition exception) but applying to some cases of subsequent fair value measurement, if the tax effect is already included in the fair value; and

    (b) to introduce the entity's expectation of future dividend payments in deciding the applicable tax rate, rather than simply to use the tax rate that applies to undistributed profits.

68. The Board could also choose this option to address some Type One issues. For example, it could consider using OCI to bridge between the result of the balance sheet liability approach and the result of another approach if the Board concludes that the former approach would produce less relevant information, in profit or loss, than the latter. This would not be completely consistent with the Exposure Draft *Conceptual Framework for Financial Reporting*, published in May 2015, because paragraph 7.24(a) of that Exposure Draft would not permit the use of OCI for assets that are not measured at current value. Arguably, this has some similarities to some of the Type One issues that arise when the tax base, as opposed to the carrying amount, of an asset is measured at current value.

69. The Board could undertake those narrow scope amendments on a selective basis, according to their priorities. The Board could also investigate the possibility of undertaking some narrow scope amendments after the post-implementation review of other IFRS Standards, such as IFRS 13 *Fair Value Measurement*.

70. According to the 2013 EFRAG Feedback Statement, many respondents supported an approach similar to Option 2. However, there were concerns that the more exceptions the Board creates in IAS 12, the more sceptical people would be about the usefulness of the main principles and that it would not be clear what the amendments would achieve if there is no overall vision of what the accounting model has to show. If the Board thinks that it would end up creating many exceptions by a series of narrow scope amendments, it should consider a fundamental change in the main principle, even though this has some disadvantages highlighted previously.

Option 3: Improvement of tax disclosures

71. The Board could consider undertaking a project to improve the quality of tax disclosures. Although there are a number of practice issues in application of IAS 12, users do not seem to be very concerned about those issues. Based on the staff analysis, this is not because the issue is irrelevant to investment decisions by users but because tax information disclosed is complex and lacks transparency, and so users find it hard to determine whether a particular tax issue is important to them. Therefore, the staff think it is reasonable for the Board to consider undertaking a project to improve tax disclosures as a first step, before considering whether to undertake any further project to improve the main principles in IAS 12.

72. If the Board decides to take this option, it could consider not only improving the existing disclosure issues in Type Three but also requiring additional information to help users better understand the effect of some application issues in Type One and Type Two. The Board could also consider the possibility of improving the presentation and disclosure of income tax expense in the interim financial statements (paragraph 62(b)).

73. In conducting a project under this option, the Board could consider recent development in international tax administration. For example, since 2013, the Organisation for Economic Co-operation and Development (OECD), together with G20, has been working on a project called Base Erosion and Profit Shifting (BEPS). BEPS refers to the tax planning strategies that exploit gaps and the

mismatching of tax rules to artificially shift profits to low or no tax locations where there are no or only limited economic activities. This shift results in little or no corporate tax being paid. To tackle those tax strategies, the OECD has identified 15 actions to be taken, including Action 13: *Guidance on Transfer Pricing Documentation and Country by Country Reporting* (CbC Report), which affects large multinationals.

74. Action 13 provides guidance on transfer pricing documentation eg to prepare a package incorporating a master file, local file, and, for large multinationals a CbC Report.[17] The CbC Report will be prepared annually and, for each jurisdiction in which the multinational does business, it will identify the amount of revenue, profit before income taxes, income tax paid and accrued, the number of its employees, stated capital, retained earnings and tangible assets. It also requires the identification of each entity within the group doing business in a particular jurisdiction and for each entity to provide an indication of the business activities it engages in. The CbC Report will then be shared between the tax authorities in different jurisdictions in order to assist them in obtaining a greater understanding of how a multinational operates and pays its tax globally. This guidance is not legally binding but is expected to be implemented as law in various jurisdictions for fiscal years beginning on or after 1 January 2016.

75. The CbC Report is used only by the governments and, in some jurisdictions, by the qualified researchers under strict confidentiality rules[18]. However, users of financial statements have also indicated that they need greater transparency in the areas of tax strategy, tax risk and tax cash flow disclosures (see Appendix B: Feedback from Investor Outreach (Agenda Paper 19C)).

[17] Multinationals with annual consolidated group revenue in the immediately preceding fiscal year of less than €750 million or a near equivalent amount in domestic currency will be exempted from this reporting.

[18] In addition, on 12 April 2016, the European Commission proposed public disclosure of key tax information on a country by country basis.

76. The 2013 EFRAG Feedback Statement reported that a large majority of respondents considered that the primary focus should be on developing better, not necessarily more, disclosure. Option 3 is in line with what EFRAG heard in 2013 and could be a practical approach to begin with. One reservation is that tax information is often sensitive and a project to make tax disclosures more transparent would attract much attention from preparers and others, as occurred during the BEPS project, which attracted much attention from multinational entities.

Option 4: Develop educational materials

77. In 2012, the Board published educational materials on fair value measurement in response to various jurisdictions' concerns about applying fair value measurement principles. Similarly, the Board could undertake a project to develop educational materials on the application of IAS 12 in order to help with its consistent application. The possible areas to be covered by educational materials could include the following:

    (a) The nature of the information produced by the temporary difference approach.

    (b) Guidance on assessing recoverability of a deferred tax asset (or valuation allowance) when an entity has a history of tax losses incurred in the past. [19]

    (c) Guidance on the meaning of substantive enactment of tax law.

    (d) Allocation of current and deferred taxes within a group that files a consolidated tax return.

[19] As noted in the ESMA *Report on Enforcement and Regulatory Activities of Accounting Enforcers in 2015*, ESMA believes that there is still room for improvement in application of the IAS 12 requirements related to the recognition, measurement and disclosures of deferred tax assets arising from tax losses.

(e) The introduction of an initial step to consider whether the recovery of an asset or settlement of liability will affect taxable profit.

Option 5: Do no further work

78. The Board could decide to do no further work in the research project on accounting for income taxes. This option will allow the Interpretations Committee to keep working on income tax issues, provide guidance where appropriate, or refer to the Board issues that are difficult to solve without changing IAS 12. The issue of the corporate wrapper (see paragraph 43(b)) is a subject which the Interpretations Committee has already discussed and decided to ask the Board to consider in its research project on income taxes. The Board may have to consider the corporate wrapper, if it takes this option; although, it could wait until the Interpretations Committee refers more issues to it.