STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	**IAS 33 *Earnings per Share*—Tax arising from payments on participating equity instruments**
Paper topic	Agenda decision to finalise

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Introduction

1. The IFRS Interpretations Committee (the Committee) received a request to clarify how an entity determines profit attributable to ordinary shareholders when calculating basic earnings per share (EPS). In the fact pattern described in the submission:

   (a) the entity has two classes of equity instruments—ordinary shares and participating equity instruments. Participating equity holders participate in dividends together with ordinary shareholders according to a predetermined formula;

   (b) applying IAS 32 *Financial Instruments: Presentation*, the entity classifies the participating equity instruments as equity. Dividends are paid to participating equity holders only when they are paid to ordinary shareholders; and

   (c) the dividends on participating equity instruments are deductible for tax purposes. Accordingly, such payments reduce taxable income and thus reduce income taxes payable to the taxation authorities ('tax benefit').

2. The submitter asked whether, in determining profit attributable to the ordinary shareholders (ie the numerator) in the basic EPS calculation, the entity reflects the tax

benefit that would arise from the hypothetical distribution of profit to participating equity holders.

3. Paragraph A14 of IAS 33 requires an entity to allocate profit or loss to the different classes of shares and participating equity instruments in accordance with their dividend rights and other rights to participate in undistributed earnings. Paragraph A14 of IAS 33 also requires an entity to allocate profit or loss (after adjusting for cumulative dividends and dividends declared in the period) to ordinary shares and participating equity instruments to the extent that each instrument shares in earnings as if all of the profit or loss for the period had been distributed (ie the hypothetical distribution).

4. The Committee concluded that when calculating basic EPS, the entity adjusts profit or loss attributable to ordinary shareholders for the portion of any tax benefit attributable to those ordinary shareholders. This is because the tax benefit is a direct consequence of the hypothetical distribution of profit to the participating equity holders required by paragraph A14 of IAS 33. The entity applies this accounting treatment regardless of whether it recognises the tax benefit in equity or in profit or loss.

5. The Committee observed that this treatment is also consistent with the objective of basic EPS outlined in paragraph 11 of IAS 33—namely, to provide a measure of the interests of each ordinary share in the performance of the entity over the reporting period.

6. The Committee concluded that the principles and requirements in IAS 33 provide an adequate basis for an entity to calculate basic EPS in the fact pattern described in the submission. Consequently, the Committee tentatively decided not to add this matter to its standard-setting agenda.

7. The Committee also decided to consider an example applying the Committee's tentative conclusions at a future meeting. The example would illustrate the accounting over a number of reporting periods.

8. The purpose of this paper is to:

   (a) present an example that applies the Committee's tentative conclusions and illustrates the accounting over a number of reporting periods;

   (b) analyse the comments received on the tentative agenda decision; and

   (c) ask the Committee if it agrees with the staff recommendation to finalise the agenda decision.

Structure

9. This paper is structured as follows:

   (a) summary of the example;

   (b) comment letter summary;

   (c) staff analysis; and

   (d) staff recommendations.

10. There are three appendices to this paper:

   (a) Appendix A—proposed wording for final agenda decision;

   (b) Appendix B—example; and

   (c) Appendix C—copies of comment letters.

Example

11. The example set out in Appendix B to this paper illustrates how an entity would apply the Committee's tentative conclusions when it determines the profit attributable to ordinary shareholders (ie the numerator in the basic EPS calculation) over three reporting periods. The example assumes that the entity makes dividend payments in years 2 and 3.

Staff recommendation

12. We recommend publishing the example in Appendix B to this paper as educational material to accompany the agenda decision.

Comment letter summary

13. We received four comment letters, which we have reproduced in Appendix C to this paper.

14. Two respondents (Accounting Standards Committee of Germany (ASCG) and Deloitte) agree with the conclusions reached by the Committee.

15. One respondent (Mazars) supports the Committee's conclusions in theory. Nonetheless, the respondent says that the Committee has not yet completed its analysis because it is yet to consider an example. Accordingly, Mazars says that the Committee should not finalise the agenda decision, but instead should extend the comment period, so that stakeholders are able to provide comments based on a comprehensive analysis.

16. One respondent (EY) says that it understands why the Committee makes an analogy to paragraph A14 of IAS 33. EY asks the Committee to clarify which principle in IAS 33 supports its conclusion. EY questions whether the Committee's conclusions also apply more generally to the tax effects of actual and hypothetical distributions of profit or loss and how an entity would apply this model in loss situations.

17. Deloitte welcomes the proposal to provide an illustrative example applying the Committee's conclusions. Deloitte recommends that the example cover the calculation of basic EPS for both a period in which the entity generates profits and a later period in which the entity pays a dividend to participating equity holders.

18. The ASCG suggests the Committee further consider some aspects when developing the final agenda decision. In particular it requests further clarification on:

    (a) how an entity determines the portion of the tax benefit attributable to ordinary shareholders; and

    (b) how an entity determines the portion of the tax benefit attributable to ordinary shareholders if participating equity holders would also share in any distribution of the tax benefits.

19. Further details on these matters, together with our analysis, is presented in the following section.

Staff analysis

Determining the portion of the tax benefit attributable to ordinary shareholders

Matter raised by respondent

20. In the fact pattern described in the submission, the submitter noted that the tax benefit is attributable to the ordinary shareholders. The ASCG asks the Committee to clarify how an entity determines the portion of the tax benefit attributable to ordinary shareholders in situations in which:

    (a) the participating shareholders participate in dividends but do not participate in liquidation proceeds; and

    (b) the ordinary shareholders control the distribution of any dividends.

21. The ASCG says that, in these situations, the participating equity holders do not have a right to participate in tax benefits until and unless the ordinary shareholders decide to distribute the tax benefit as dividend.

Staff analysis

22. Paragraph A14 of IAS 33 states that '…profit or loss for the period is allocated to the different classes of shares and participating equity instruments in accordance with their dividend rights or other rights to participate in undistributed earnings…'. Further, paragraph A14(b) of IAS 33 states that 'the remaining profit or loss is

allocated to ordinary shares and participating equity instruments to the extent that each instrument shares in earnings as if all of the profit or loss for the period had been distributed…'

23. We think that the agenda decision should not discuss how an entity determines the portion of the tax benefit attributable to ordinary shareholders. This assessment depends on the rights of the ordinary shareholders and participating equity holders, which very much depends on the particular shareholder agreements. Accordingly, we think the Committee would not be in a position to comment further on this assessment. In addition, we think such an assessment is not unique to the tax benefit, but to any dividend rights of the participating equity holders.

Determining the appropriate portion of tax benefit attributable to ordinary shareholders

Matter raised by respondent

24. In the fact pattern described in the submission, the submitter noted that the tax benefit is attributable to the ordinary shareholders. The ASCG asks the Committee to clarify how an entity would allocate any remaining profit between ordinary shareholders and participating equity holders in situations in which the participating equity holders would share in the tax benefit with the ordinary shareholders. This is because a hypothetical distribution of profit to participating equity holders would give rise to a tax benefit, and the hypothetical distribution of a portion of this tax benefit to participating equity holders would itself give rise to a further tax benefit. There is therefore an iterative process to calculate the tax benefit attributable to ordinary shareholders. The ASCG asks whether an entity applies this iterative process when determining the profit or loss attributable to ordinary shareholders.

25. The ASCG notes that paragraphs 12-14 of IAS 33 require an entity to adjust profit or loss attributable to ordinary shareholders by the amount of after-tax dividend on preference shares. Accordingly, any tax benefit that results from dividend payments on preference shares is attributed to the ordinary shareholders and is not allocated between the ordinary shareholders and the preference shareholders.

Staff analysis

26. Notwithstanding the fact pattern described in the submission, at its meeting in March 2017, the Committee considered how an entity calculates the tax benefit attributable to ordinary shareholders if the tax benefit is shared between the ordinary shareholder and participating equity holders.

27. Paragraph A14(b) of IAS 33 requires an entity to allocate any remaining profit or loss (after adjusting for any dividends paid during the period or any cumulative dividends required to be paid):

> …to ordinary shares and participating equity instruments to the extent that each instrument shares in earnings as if all of the profit or loss for the period had been distributed…

28. In its discussions, the Committee observed that if the hypothetical distribution of profit would give rise to a tax benefit, the entity would also make a hypothetical distribution of any tax benefit in accordance with the instruments' dividend and other rights. If this hypothetical distribution of the tax benefit would itself give rise to an additional tax benefit, the entity would also assume a distribution of this additional tax benefit until it has made a hypothetical distribution of all amounts.

29. In the example described in Appendix B to this paper, the profit for year 1 (before any tax benefit) is CU330. The hypothetical distribution of CU300 to participating equity holders would give rise to a tax benefit of CU90. If the participating equity holders and the ordinary shareholders shared 10:1 in any tax benefit, the entity would allocate the CU90 between the ordinary shareholders and the participating equity holders—the participating equity holders would receive CU82 and the ordinary shareholders would receive CU8. The distribution of CU82 to participating equity holders would give rise to a further tax benefit of CU25 (30% of CU82). The entity would then allocate this tax benefit between the participating equity holders and the ordinary shareholders and continue this process until it has made a hypothetical distribution of all amounts.

30. Paragraphs 12-14 of IAS 33 set out how an entity adjusts profit or loss attributable to ordinary shareholders for preference dividends. The requirements for participating equity holders are set out in paragraph A14 of IAS 33—the entity applies the requirements set out in paragraph A14 of IAS 33 in the fact pattern described in the

submission. It would not analogise to the treatment of preference dividends in paragraphs 12-14 of IAS 33.

31. We think the Committee does not need to make any clarification to the agenda decision in respect of this matter. The agenda decision states:

> '…the entity adjusts profit or loss attributable to ordinary shareholders for the portion of any tax benefit attributable to those ordinary shareholders'

32. In addition, the example in Appendix B clarifies the calculation in this respect. It states that if the ordinary shareholders and participating equity holders were to share the tax benefit in the same proportion as other dividend payments (for example, ten to one), an entity would allocate the dividend related to the tax benefit using the relevant ratio to calculate the amount of the dividend attributable to ordinary shareholders and participating equity holders.

Analogy to paragraph A14 of IAS 33 and clarifying the requirements

Matter raised by respondent

33. One respondent (EY) says that they understand why the Committee makes an analogy to paragraph A14 of IAS 33. EY asks the Committee to clarify which principle in IAS 33 supports its conclusion. EY questions whether, and how, an entity applies the Committee's conclusions more generally to the tax effects of actual and hypothetical distributions of profit or loss, for example in the following situations:

(a) when a tax benefit would arise on a hypothetical distribution of profit to ordinary shareholders;

(b) when different tax rates would apply to distributions to ordinary shareholders and participating equity holders; and

(c) when the entity reports a loss.

Staff analysis

34. Paragraph A14 of IAS 33 contains requirements that an entity applies in determining basic EPS in situations in which an entity has participating equity instruments. The entity described in the submission does not apply these requirements by analogy—

rather, it applies these requirements because they are directly applicable to the fact pattern.

35. The tentative agenda decision specifies that in the fact pattern described in the submission, an entity adjusts profit or loss attributable to ordinary shareholders for the portion of any tax benefit attributable to those ordinary shareholders ‘because the tax benefit is a direct consequence of the hypothetical distribution of profit to the participating equity holders required by paragraph A14 of IAS 33’. The Committee’s conclusions are supported by the requirements in paragraph A14 of IAS 33, as noted in the agenda decision.

36. Applying these requirements to the situations identified by the respondent in paragraph 33 of this paper depends on the facts and circumstances. To the extent a hypothetical distribution of profit or loss to the ordinary shareholders and the participating equity holders as required by paragraph A14 of IAS 33 would result in a tax consequence, an entity would take account of the tax consequence when determining the profit or loss attributable to ordinary shareholders. In determining this tax consequence, an entity would apply the applicable tax rates that would apply to the hypothetical distribution of profit or loss to ordinary shareholders and participating equity holders.

Finalising the agenda decision

Matter raised by respondent

37. Mazars says that the Committee has not yet completed its analysis because it has yet to consider an example. Accordingly, it says that the Committee should not finalise the agenda decision, but rather should extend the comment period, so that stakeholders are able to provide comments based on a comprehensive analysis.

Staff analysis

38. We do not agree. At its discussion in March 2017, the Committee considered the matter and, in our view, completed all relevant technical discussions. The Committee asked us to provide them with an example at a future meeting—the purpose of the example was not to reconsider the technical conclusions the Committee reached, but

rather, to illustrate how an entity would apply the Committee's conclusions, in particular, over a number of reporting periods.

Staff recommendation

39. Based on our analysis, we recommend:

    (a) confirming the tentative agenda decision as published in the IFRIC Update in March 2017 with no changes—Appendix A to this paper sets out the draft wording for the final agenda decision; and

    (b) publishing the example set out in Appendix B to this paper as educational material.

Question for the Committee
Does the Committee agree with our recommendation to: a. finalise the agenda decision set out in Appendix A to this paper; and b. publish the example set out in Appendix B to this paper as educational material?

Appendix A—Proposed wording for final agenda decision

A1. We propose the following wording for the final agenda decision, which is unchanged from the tentative agenda decision except to remove the square brackets in the last sentence.

IAS 33 *Earnings per Share*—Tax arising from payments on participating equity instruments

The Committee received a request to clarify how an entity determines profit attributable to ordinary shareholders when calculating basic earnings per share (EPS). In the fact pattern described in the submission:

a. the entity has two classes of equity instruments—ordinary shares and participating equity instruments. Participating equity holders participate in dividends together with ordinary shareholders according to a predetermined formula;
b. applying IAS 32 *Financial Instruments: Presentation*, the entity classifies the participating equity instruments as equity. Dividends are paid to participating equity holders only when they are paid to ordinary shareholders; and
c. the dividends on participating equity instruments are deductible for tax purposes. Accordingly, such payments reduce taxable income and thus reduce income taxes payable to the taxation authorities (‘tax benefit’).

The submitter asked whether, in determining profit attributable to the ordinary shareholders (ie the numerator) in the basic EPS calculation, the entity reflects the tax benefit that would arise from the hypothetical distribution of profit to participating equity holders.

Paragraph A14 of IAS 33 requires an entity to allocate profit or loss to the different classes of shares and participating equity instruments in accordance with their dividend rights and other rights to participate in undistributed earnings. Paragraph A14 of IAS 33 also requires an entity to allocate profit or loss (after adjusting for cumulative dividends and dividends declared in the period) to ordinary shares and participating equity instruments to the extent that each instrument shares in earnings as if all of the profit or loss for the period had been distributed (ie the hypothetical distribution).

The Committee concluded that, when calculating basic EPS, the entity adjusts profit or loss attributable to ordinary shareholders for the portion of any tax benefit attributable to those ordinary shareholders. This is because the tax benefit is a direct consequence of the hypothetical distribution of profit to the participating equity holders required by paragraph A14 of IAS 33. The entity applies this accounting treatment regardless of whether it recognises the tax benefit in equity or in profit or loss.

The Committee observed that this treatment is also consistent with the objective of basic EPS outlined in paragraph 11 of IAS 33—namely, to provide a measure of the interests of each ordinary share in the performance of the entity over the reporting period.

The Committee concluded that the principles and requirements in IAS 33 provide an adequate basis for an entity to calculate basic EPS in the fact pattern described in the submission. Consequently, the Committee ~~[~~decided~~]~~ not to add this matter to its standard-setting agenda.

Appendix B—Example

B1. This example illustrates how an entity (Entity A) determines profit or loss attributable to ordinary shareholders (ie the numerator in the basic earnings per share (EPS) calculation) over three reporting periods. Entity A has two classes of equity instruments outstanding—ordinary shares and participating equity instruments.

Assumptions

B2. In this example:

(a) participating equity holders participate in dividends together with ordinary shareholders according to a 10:1 ratio (except for any distribution relating to the tax benefit – see paragraphs B2(b) and B2(c) below).

(b) the dividends on participating equity instruments are deductible for tax purposes. Accordingly, such payments reduce taxable income and thus reduce income taxes payable to the taxation authority ('tax benefit').

(c) ordinary shareholders (and not participating equity holders) benefit from the tax benefit. The tax rate is 30 per cent.

B3. We have also assumed that:

(a) Entity A's profit applying IFRS Standards for years 1, 2 and 3 are CU330, CU550 and CU110 respectively—before considering any tax benefit that arises from paying dividends to participating equity holders.

(b) Entity A does not declare or pay dividends during year 1.

(c) at the end of year 2, Entity A declares and pays dividends for:

(i) all the profit in year 1 of CU330; and

(ii) the tax benefit that arises from paying dividends to the participating equity holders.

(d) at the end of year 3, Entity A declares and pays dividends for:

(i) all the profit in years 2 and 3; and

(ii) the tax benefit that arises from paying dividends to the participating equity holders.

The following summarises Entity A's profit, dividends paid and the tax benefit in each of the three years (in CUs):

	Year 1	Year 2	Year 3	Total
Profit before tax benefit	**330**	**550**	**110**	**990**
Dividends declared and paid (before considering the tax benefit):	**0**	**330**	**660**	**990**
To participating equity holders (in ratio of 10:1) [A]	0	300	600	900
To ordinary shareholders (in ratio of 10:1)	0	30	60	90
Tax benefit from paying dividends [A x 30%]	**0**	**90**	**180**	**270**
Dividends declared and paid relating to the tax benefit:	**0**	**90**	**180**	**270**
To participating equity holders	0	0	0	0
To ordinary shareholders[1]	0	90	180	270
Total dividends declared and paid:	**0**	**420**	**840**	**1,260**
To participating equity holders	0	300	600	900
To ordinary shareholders	0	120	240	360

Step I—adjust profit for the amount of dividends declared

B4. Paragraph A14(a) of IAS 33 states:

> profit or loss attributable to ordinary equity holders of the parent entity is adjusted (a profit reduced and a loss increased) by the

[1] In this example, ordinary shareholders (and not participating equity holders) benefit from the tax benefit. However, if that were not the case, and ordinary shareholders and participating equity holders were to share the tax benefit in the same proportion as other dividend payments (for example, ten to one), an entity would allocate the dividend related to the tax benefit using the relevant ratio.

> amount of dividends declared in the period for each class of shares and by the contractual amount of dividends (or interest on participating bonds) that must be paid for the period (for example, unpaid cumulative dividends).

B5. The following illustrates how Entity A applies this requirement:

	Year 1	Year 2	Year 3	Total
Profit (before tax benefit)	**330**	**550**	**110**	**990**
Tax benefit from paying dividends	0	90	180	270
Profit (after tax benefit)[2]	**330**	**640**	**290**	**1,260**
Less: total dividends declared and paid (including the tax benefit)	**0**	**(420)**	**(840)**	**(1,260)**
To participating equity holders	0	300	600	900
To ordinary shareholders	0	120	240	360
Remaining profit	**330**	**220**	**(550)**	**0**

Step II—allocation of the remaining profit

B6. Paragraph A14(b) of IAS 33 states:

> the remaining profit or loss is allocated to ordinary shares and participating equity instruments to the extent that each instrument shares in earnings as if all of the profit or loss for the period had been distributed…

[2] In this example, Entity A recognises the tax benefit arising from the distribution of dividends in profit or loss. If an entity were to recognise the tax benefit directly in equity, the entity would adjust profit or loss for the period for the tax benefit when calculating basic EPS. The objective of basic EPS is to 'provide a measure of the interests of each ordinary share…'. Adjusting profit or loss for any tax benefit is consistent with the view that the tax benefit represents an interest of the ordinary shareholder.

B7. The following illustrates how Entity A applies this requirement:

	Year 1	Year 2	Year 3	Total
Remaining profit	**330**	**220**	**(550)**	**0**
Allocation:				
To participating equity holders [B]	**300**	**200**	**(500)**	**0**
To ordinary shareholders	30	20	(50)	0
Add: tax benefit[3] [B x 30%]	90	60	(150)	0
To ordinary shareholders	**120**	**80**	**(200)**	**0**

Step III—add together the amount allocated for dividends and for a participating feature

B8. Paragraph A14(b) of IAS 33 states:

> …The total profit or loss allocated to each class of equity instrument is determined by adding together the amount allocated for dividends and the amount allocated for a participation feature.

B9. The following illustrates how Entity A applies this requirement to calculate profit or loss attributable to ordinary shareholders (ie the numerator for calculating basic EPS):

	Year 1	Year 2	Year 3	Total
Profit or loss attributable to ordinary shareholders:	**120**	**200**	**40**	**360**
Dividends declared	0	120	240	360
Remaining profit allocated	120	80	(200)	0

[3] Adjustment to reflect the Committee's conclusion that Entity A adjusts profit or loss attributable to ordinary shareholders for the portion of any tax benefit attributable to those ordinary shareholders. This tax benefit would arise on the hypothetical distribution of profit to the participating equity holders if all the profit or loss for the period had been distributed. The tax benefit is calculated as the hypothetical distribution (allocation) to participating equity holders multiplied by the tax rate (ie 30%).

B10. The total profit or loss attributable to ordinary shareholders in each year (CU120, CU200 and CU40 in year 1, 2 and 3 respectively) reflects the ordinary shareholders' share of:

a. profit from the year (CU30, CU50 and CU10 for year 1, 2 and 3 respectively); plus

b. the tax benefit which would arise on the hypothetical distribution of profit from that year to the participating equity holders (CU90, CU150 and CU30 for years 1, 2 and 3 respectively[4]).

[4] Calculated as share of participating equity holder's share of profits of CU300, CU500 and CU100 in years 1,2 and 3 respectively multiplied by the tax rate of 30%.

Appendix C—Copies of comment letters