STAFF PAPER

March 2020

IFRS® Interpretations Committee meeting

Project	**Deferred tax related to a Subsidiary's Undistributed Profits (IAS 12)**		
Paper topic	Initial consideration		
CONTACT(S)	Gustavo Olinda	golinda@ifrs.org	+44 (0) 20 7246 6481
	Jawaid Dossani	jdossani@ifrs.org	+44 (0) 20 7332 2742

Introduction

1. The IFRS Interpretations Committee (Committee) received a submission about IAS 12 *Income Taxes*. The submitter asks how an entity, in its consolidated financial statements, accounts for deferred tax related to undistributed profits of a subsidiary in a jurisdiction in which income tax is payable only on distribution of profits.

2. This paper:

   (a) provides the Committee with a summary of the matter;

   (b) presents our research and analysis; and

   (c) asks the Committee whether it agrees with our recommendation not to add the matter to its standard-setting agenda.

Structure of the paper

3. This paper includes the following:

   (a) background information;

(b) summary of outreach;

(c) staff analysis; and

(d) staff recommendation.

4. There are three appendices to the paper:

(a) Appendix A—proposed wording of the tentative agenda decision;

(b) Appendix B—illustrative examples; and

(c) Appendix C—submission.

Background information

Overview of the applicable requirements in IAS 12

5. The submission refers to the requirements in IAS 12 relating to:

(a) tax rates based on distribution and the tax consequences of dividends; and

(b) deferred tax related to investments in subsidiaries.

6. Paragraphs 7–12 of this paper provide an overview of these requirements and Appendix B to this paper includes two examples illustrating their application.

Tax rates based on distribution and the tax consequences of dividends

7. Paragraph 52A of IAS 12 states:

> In some jurisdictions, income taxes are payable at a higher or lower rate if part or all of the net profit or retained earnings is paid out as a dividend to shareholders of the entity. In some other jurisdictions, income taxes may be refundable or payable if part or all of the net profit or retained earnings is paid out as a dividend to shareholders of the entity. In these circumstances, current and deferred tax assets and liabilities are measured at the tax rate applicable to undistributed profits.

8. Paragraph 57A of IAS 12 requires an entity to recognise the income tax consequences of dividends when it recognises a liability to pay a dividend. This requirement complements paragraph 52A—any additional tax payable or refundable arising from

the difference in tax rates applicable to distributed and undistributed profits is considered a tax consequence of the dividend payment.

Deferred tax related to investments in subsidiaries

9. Paragraphs 38–45 of IAS 12 prescribe how an entity accounts for deferred tax related to investments in subsidiaries, branches and associates and interests in joint arrangements.[1]

10. Paragraph 38 states that temporary differences arise when the carrying amount of investments in subsidiaries (namely, the parent's share of the net assets of the subsidiary, including the carrying amount of goodwill) becomes different from the tax base of the investment. Such differences may arise, for example, because of undistributed profits of subsidiaries.[2] This is because undistributed profits generally increase the carrying amount of the investment but might not result in any change to its tax base.

11. Paragraph 39 requires an entity to recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, except to the extent that (a) the entity is able to control the timing of the reversal of the temporary difference; and (b) it is probable that the temporary difference will not reverse in the foreseeable future (recognition exception).

12. Paragraph 40 explains that, because an entity controls its subsidiary's dividend policy, it is able to control the timing of reversal of temporary differences associated with its investment in the subsidiary. Condition (a) of the recognition exception (see paragraph 11 above) would therefore be satisfied. The entity would then consider whether it is probable that the subsidiary will distribute its profits in the foreseeable future. To the extent such distributions are probable, the recognition exception would not apply and the entity would recognise a related deferred tax liability.

---

[1] For ease of reading, we refer only to investments in subsidiaries when describing the requirements in IAS 12.

[2] Those differences are often referred to as 'outside basis' differences.

Background to the submission

13. The submitter asks how an entity, in its consolidated financial statements, accounts for deferred tax related to its investment in a subsidiary when:

    (a) undistributed profits of the subsidiary give rise to a taxable temporary difference associated with the entity's investment in the subsidiary;

    (b) the conditions to apply the recognition exception are not satisfied because the entity expects the subsidiary to distribute its undistributed profits in the foreseeable future; and

    (c) the entity and subsidiary operate in a jurisdiction in which:

        (i) profits are taxable only when distributed—ie the income tax rate applicable to undistributed profit is 0% (undistributed tax rate);

        (ii) a 20% tax rate applies to any profit distributions (distributed tax rate)—eg a profit distribution of CU100 results in tax payable of CU20, and a net distribution to shareholders of CU80;

        (iii) distributions are taxable only once—ie a subsidiary is taxed when it makes profit distributions to a parent, but any further distributions of that profit within the group, or to the group's shareholders, are not taxable; and

        (iv) the tax paid by the subsidiary is the subsidiary's tax liability; it is not a withholding tax paid on behalf of its parent.

14. The submitter says the fact pattern exists in Estonia and that similar fact patterns exist in other countries, such as Latvia, Georgia and Macedonia.

15. The submitter outlines the following views on the accounting for deferred tax related to the investment in the subsidiary:

    (a) *View 1: the entity recognises no deferred tax*—applying paragraph 52A of IAS 12 (see paragraph 7 of this paper), the entity applies the undistributed tax rate of 0% to the taxable temporary difference associated with its investment in the subsidiary. Therefore, the entity recognises no deferred tax in respect of that temporary difference. Instead, applying paragraph 57A of IAS 12 (see paragraph 8 of this paper), the entity recognises income tax only when the subsidiary makes a distribution. The submitter says entities in Estonia generally apply this view.

(b) *View 2*: *the entity recognises deferred tax*—applying paragraphs 39–40 of IAS 12 (see paragraphs 9–12 of this paper), the entity recognises a deferred tax liability for the taxable temporary difference associated with its investment in the subsidiary. According to View 2, paragraphs 52A and 57A of IAS 12 do not apply to the accounting for deferred tax related to investments in subsidiaries.

16. The submitter says these different views exist because of a potential inconsistency between the requirements in:

(a) paragraphs 52A and 57A (see paragraphs 7–8 of this paper)—which require an entity to (a) measure current and deferred tax using the tax rate applicable to undistributed profits; and (b) recognise income tax consequences of dividends only when an entity recognises the dividend; and

(b) paragraph 39–40 (see paragraphs 9–12 of this paper)—which require an entity to recognise deferred tax for all taxable temporary differences associated with investments in subsidiaries, unless the recognition exception applies.

17. Appendix C to this paper reproduces the submission which provides further details about each view, including a numeric example illustrating differences in outcome.

Summary of outreach

18. We sent information requests to members of the International Forum of Accounting Standard-Setters, securities regulators, and large accounting firms. The submission was also made available on our website.

19. The request asked those participating to provide information about whether, based on their experience, the fact pattern described in the submission is common. If the fact pattern is common, we asked in which jurisdictions it is common, and what is the accounting applied.

20. We received 12 responses—six from national standard-setters, five from large accounting firms and one from an organisation representing a group of securities regulators. The views received represent informal opinions and do not reflect the official views of those respondents or their organisations.

Findings from outreach

Is the fact pattern common?

21. Many respondents say the fact pattern is common in the jurisdictions identified by the submitter (ie Estonia, Latvia, Georgia and North Macedonia).[3] One respondent also says the fact pattern is common in Israel, and another says similar fact patterns exist in other jurisdictions. Other respondents say the fact pattern is not common in their jurisdictions.

What is the accounting applied?

22. Respondents who comment on the accounting say they have observed differences in the accounting for deferred tax—some entities recognise deferred tax (View 2) whilst some do not (View 1). Some respondents say entities in Estonia apply View 1 and entities in Latvia apply View 2.

23. Some respondents provide their view on the application of IAS 12—most of these respondents say an entity should recognise deferred tax in the fact pattern described in the submission (ie View 2).

Staff analysis

Recognising and measuring deferred tax

24. Paragraph 39 of IAS 12 requires an entity to recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, unless the recognition exception applies.

[3] One respondent says the fact pattern was, but no longer is, applicable to North Macedonia.

25. In the fact pattern described in the submission (a) there is a taxable temporary difference associated with the entity's investment in the subsidiary because of the subsidiary's undistributed profits; and (b) the recognition exception does not apply. Therefore, applying the requirements in paragraph 39 of IAS 12 an entity recognises a deferred tax liability for that taxable temporary difference.

26. In measuring the deferred tax liability, the entity considers the requirements in paragraph 51 of IAS 12, which states:

> The measurement of deferred tax liabilities and deferred tax assets shall reflect the tax consequences that would follow from the manner in which the entity expects, at the end of the reporting period, to recover or settle the carrying amount of its assets and liabilities.

27. Paragraph 51A states:

> In some jurisdictions, the manner in which an entity recovers (settles) the carrying amount of an asset (liability) may affect either or both of:
>
> (a) the tax rate applicable when the entity recovers (settles) the carrying amount of the asset (liability); and
>
> (b) the tax base of the asset (liability).
>
> In such cases, *an entity measures deferred tax liabilities and deferred tax assets using the tax rate and the tax base that are consistent with the expected manner of recovery or settlement.* [Emphasis added]

28. The entity expects to recover the carrying amount of its investment in the subsidiary through distributions of profits by the subsidiary. These distributions would be taxed at the distributed tax rate (20%). Accordingly, applying paragraphs 51 and 51A of IAS 12, the entity uses the distributed tax rate to measure the deferred tax liability. Measuring the deferred tax liability using the distributed rate (20%) reflects the tax consequence of recovering the investment in the subsidiary, as well as the fact that subsequent distributions by the entity will have no further tax consequences.

Do paragraphs 52A and 57A of IAS 12 apply?

29. Paragraph 57A of IAS 12 requires an entity to recognise the income tax consequences of dividends when it recognises a liability to pay a dividend. We think that paragraph does not apply to the fact pattern described in the submission. Applying IFRS 10 *Consolidated Financial Statements*, any distribution from a subsidiary to its parent (internal distribution) is eliminated on consolidation, and therefore is not a dividend in the context of consolidated financial statements. Accordingly, in our view any tax consequence arising from such a distribution is not a tax consequence of dividends.

30. Paragraph 52A of IAS 12 applies in jurisdictions in which an entity pays a higher or lower tax rate depending on whether it distributes profits. In these circumstances, that paragraph requires an entity to measure current and deferred tax at the rate applicable to undistributed profits. However, we think this paragraph cannot apply to the measurement of a current or deferred tax that itself results from, or reflects, the tax consequence of a distribution of profits. For example, an entity applies the tax rate applicable to distributed profits when it measures a current tax liability arising from a dividend payment—it cannot apply the undistributed tax rate because that rate would not reflect the fact that the current tax liability results from a distribution of profits.

31. In the fact pattern described in the submission, the deferred tax liability recognised reflects the tax consequences of recovering the investment in the subsidiary through a distribution of profits. Accordingly, we conclude that paragraph 52A does not apply.

Amendments to IAS 12 in 2000

32. In October 2000, the Board amended IAS 12 (2000 amendments). The 2000 amendments added paragraphs 52A and 52B (the requirements in paragraph 52B have since been moved to paragraph 57A) and deleted paragraph 3. Before the 2000 amendments, paragraph 3 of IAS 12 had stated:

> In some jurisdictions, income taxes are payable at a higher or lower rate if part or all of the net profit or retained earnings is paid out as a dividend. In some other jurisdictions, income taxes may be refundable if part or all of the net profit or retained earnings is paid out as a dividend. This Standard does not specify when, or how, an enterprise should account for the tax

consequences of dividends and other distributions by the reporting enterprise.

33. The purpose of the amendments was therefore to specify the accounting for tax consequences of dividends of the *reporting entity*, not those of internal distributions. Furthermore, Agenda Paper 7 for the International Accounting Standards Committee's October 2000 meeting clarifies that the accounting for dividends from subsidiaries to a parent was not part of the project. Among the reasons for that decision, it was noted that Example 3 of the Illustrative Examples accompanying IAS 12 provides some guidance in that respect. That example illustrates that an entity considers the expected manner of recovery in determining whether to recognise deferred tax for temporary differences associated with investments in subsidiaries.

Conclusion

34. Based on our analysis in paragraphs 24–33 of this paper, we conclude that, in the fact pattern described in the submission, the entity recognises and measures a deferred tax liability that reflects the tax consequences of recovering its investment in the subsidiary. In doing so, the entity measures the deferred tax liability using the distributed tax rate. Our conclusion reflects the outcome of View 2 in the submission.

Question 1 for the Committee
1. Does the Committee agree with our analysis of the requirements in IAS 12, outlined in paragraphs 24–33 of this paper?

Should the Committee add this matter to its standard setting agenda?

Is it necessary to add to or change IFRS Standards to improve financial reporting?[4]

35. Based on our analysis in paragraphs 24–33 of this paper, we conclude that IAS 12 provides an adequate basis for an entity to account for deferred tax in the fact pattern described in the submission.

Submitter's concern

36. The submitter has expressed concern about the recognition of deferred tax in this situation. This is because the accounting for deferred tax might be different solely based on a group's legal structure. For example, an entity with two business units would recognise different amounts of deferred tax depending on whether the business units are held in one legal entity or in two separate legal entities (a parent entity and a subsidiary).[5] The submitter says it could be misleading for users of financial statements to have two otherwise identical groups account for deferred tax differently, despite being subject to the same tax regime.

Staff analysis of submitter's concern

37. We acknowledge the submitter's concern. However, we note that differences in legal structure could lead to different tax consequences in some situations. For example, in the jurisdiction described in the fact pattern (see paragraph 13 of this paper), moving profits between two business units within the same legal entity would not result in any tax consequence. However, moving profits between two business units held in different legal entities (through distributions of profit) would result in a tax consequence, regardless of whether the group subsequently pays dividends to its shareholders.

38. We also acknowledge that applying View 2 could result in an entity, in effect, recognising deferred tax for undistributed profits of a subsidiary, but not recognising deferred tax for undistributed profits of the parent. However, some would say the

[4] Paragraph 5.16(b) of the *Due Process Handbook*.

[5] The submission (reproduced in Appendix C to this paper) includes a numeric example of the outcome of applying View 2 in those circumstances.

accounting outcome that results from applying View 2 reflects the differing nature of the tax consequences—in one case, tax arises from the recovery of the investment in the subsidiary (internal distribution); in the other, tax arises from the distribution of dividends to the group's shareholders.

39. Therefore, in our view, there is insufficient evidence at this stage to justify reconsidering the requirements in IAS 12 to address the submitter's concern. We are also of the view that reconsidering the applicable requirements in IAS 12 could not be done solely in the context of the fact pattern described in the submission; instead it would require a broader-scope project.

40. We note that, as part of its 2015 Agenda Consultation, the Board considered a number of unresolved concerns about the application of IAS 12, which include concerns about the application of paragraph 52A.[6] At that time, the Board decided not to prioritise further work on IAS 12. We therefore think there is also insufficient evidence at this stage to suggest that a potential project to address the submitter's concern should be prioritised ahead of (a) a potential project to address other unresolved concerns regarding IAS 12, or (b) other projects currently in the Board's research pipeline.

41. As part of its 2020 Agenda Consultation, the Board will publish a Request for Information later in the year to seek formal public input on its strategy and 2022–2026 work plan. Therefore, stakeholders who share the submitter's concern will have an opportunity to respond to the Board's Agenda Consultation and provide input to help the Board assess whether it should prioritise a project on IAS 12.

Staff recommendation

42. Based on our assessment of the Committee's agenda criteria in paragraphs 5.16–5.17 of the Due Process Handbook (discussed in paragraphs 35–41 above), we recommend that the Committee does not add this matter to its standard-setting agenda. Instead, we recommend publishing a tentative agenda decision that outlines how the applicable requirements in IAS 12 apply to the fact pattern described in the submission.

[6] See paragraphs 46–49 of Agenda Paper 19A for the May 2016 Board meeting.

43. Appendix A to this paper outlines the proposed wording of the tentative agenda decision.

Questions 2 and 3 for the Committee
2. Does the Committee agree with our recommendation not to add the matter to its standard-setting agenda? 3. Does the Committee have any comments on the proposed wording of the tentative agenda decision set out in Appendix A to this paper?

Appendix A—proposed wording of the tentative agenda decision

Deferred tax related to a Subsidiary's Undistributed Profits (IAS 12 *Income Taxes*)

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

(a) undistributed profits of the subsidiary give rise to a taxable temporary difference associated with the entity's investment in the subsidiary;

(b) the conditions for applying the exception from recognising a deferred tax liability in paragraph 39 of IAS 12 are not satisfied because the entity expects the subsidiary to distribute its undistributed profits in the foreseeable future; and

(c) the entity and subsidiary operate in a jurisdiction in which:

   (i) profits are taxable only when distributed—that is, the income tax rate applicable to undistributed profits is nil (undistributed tax rate).

   (ii) a 20% tax rate applies to profit distributions (distributed tax rate). However, profit distributions made by the entity are not taxable to the extent that the subsidiary has already been taxed on that profit.

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

Paragraph 39 of IAS 12 requires an entity to recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, except to the extent that conditions specified in that paragraph are satisfied.

In the fact pattern described in the request, there is a taxable temporary difference associated with the entity's investment in the subsidiary, and the recognition exception in paragraph 39 of IAS 12 does not apply. Accordingly, the Committee concluded that the entity recognises a deferred tax liability for that taxable temporary difference.

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

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

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

Appendix B—illustrative examples

B1. The following example illustrates how an entity applies paragraphs 52A and 57A of IAS 12:

Example A—tax rates based on distribution and the tax consequences of dividends

Entity A operates in a jurisdiction in which income taxes are payable at a lower rate on undistributed profit (20%) with an additional amount being payable when profits are distributed. The tax rate on distributed profits is 30%. At the end of the reporting period, 31 December 2019, the entity does not recognise a liability for dividends proposed or declared after the reporting period and, thus, does not recognise dividends in 2019. Entity A's taxable income for 2019 is CU100,000. On 31 March 2020, Entity A declares and pays CU100,000 (the profits for 2019) as dividends to its shareholders.

Entity A recognises a current tax liability and a current tax expense of CU20,000 (CU100,000 taxable income x 20% tax rate) in 2019. On 31 March 2020, Entity A recognises an additional current tax liability and current tax expense of CU10,000 for the additional amount payable when dividends are paid (CU100,000 dividend payment x difference between the tax rates applicable to distributed and undistributed profits of 10%).

B2. The following example illustrates how an entity applies paragraphs 38–40 of IAS 12:

Example B—deferred tax related to investments in subsidiaries

At 31 December 2019, Entity A identifies a taxable temporary difference of CU100,000 associated with its investment in Entity B, a subsidiary. This temporary difference relates to undistributed profits of Entity B, which are taxable at a tax rate of 20% if distributed. Entity A expects Entity B to distribute all its profits in the foreseeable future.

Entity A cannot apply the recognition exception in paragraph 39 of IAS 12 because it expects Entity B to distribute its profits in the foreseeable future. That distribution will result in a reversal of the taxable temporary difference associated with Entity

A's investment in Entity B. Accordingly, Entity A recognises a deferred tax liability of CU20,000 (taxable temporary difference of CU100,000 x tax rate of 20%) for the taxable temporary difference associated with its investment in Entity B.

Appendix C—submission

C1. We have reproduced the submission below:

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

The issue

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

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

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

Also in 2000, certain amendments were introduced into IAS 12 (paragraphs 12.52A and 52B) addressing tax jurisdictions like Estonia where tax is payable based on distribution rather than profit. According to IAS 12.52A, where *"income taxes are payable at a higher or lower rate if part or all of the net profit or retained earnings is paid out as a dividend to shareholders of the entity…, current and deferred tax assets and liabilities are measured at the tax rate applicable to undistributed profits."* Furthermore, IAS 12.52B (since 1 January 2019 moved to paragraph 57A)[7] clarified that *"in the circumstances described in paragraph 52A, the income tax consequences of dividends are recognized when a liability to pay the dividend is recognized."*

While those amendments to IAS 12 have made it clear that in the distribution-based tax regimes no deferred tax shall be recognised at the parent entity level until dividends are recognised, there is less clarity about the treatment of any profits arising at the subsidiary level as no similar amendments were made to the respective section in IAS 12 ("Investments in subsidiaries, branches and associates and interests in joint arrangements"; paragraphs 38-45). This section has been written in the context of "traditional" profit-based income tax

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

and does not contain any special clauses for jurisdictions where tax is paid upon profit distribution rather than profit creation.

In the context of distribution-based tax regimes (where tax is payable upon distribution rather than profit), there appears to be potential inconsistency between paragraphs 52A/57A and 39-40. While paragraphs 52A/57A stipulate that no current or deferred tax liability shall be recognised until a liability to pay dividends is recognised, paragraphs 39-40 require that deferred tax shall be recognised for all taxable differences associated with investments in subsidiaries, unless it is probable that the profits will not be distributed in the foreseeable future. This inconsistency has caused different views and market practices in countries where taxation is based on distribution rather than profit:

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

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

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

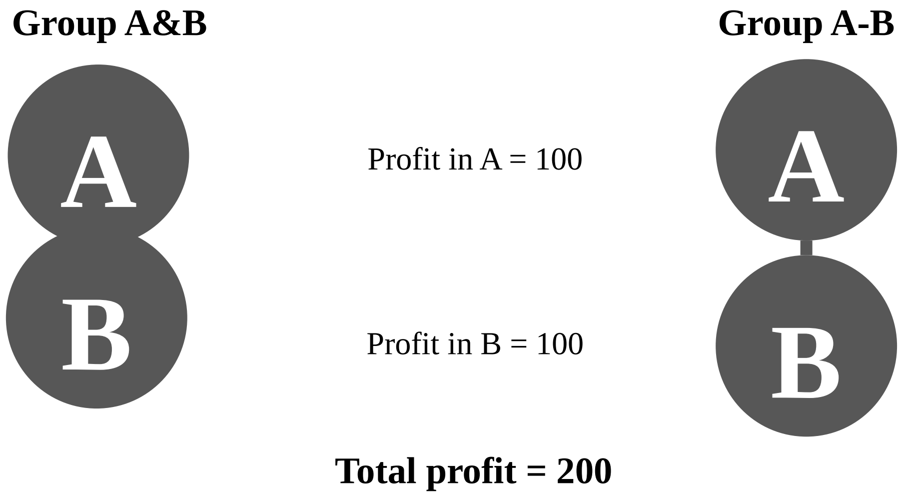
  The proponents of that view believe that the principles set out in IAS 12.52A/57A apply to the accounting for tax consequences in respect of undistributed profits arising in the parent company only and not to the subsidiaries. Instead, income tax in respect of undistributed profits retained in the subsidiary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

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

Both views are illustrated further in the example below.

<u>Example</u>

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



The consolidated balance sheets of both groups are identical and both groups earn profit of 200, out of which 100 is generated in business unit A and 100 in business unit B. Both groups operate in a jurisdiction where income tax is payable only when profit or retained earnings are paid out as dividends. Tax rate is 20% of the gross distribution.
Both groups declare and pay gross dividends of 200 on 31 March of the following year, resulting in both groups in an income tax payable of 40 and net dividends received by shareholders of 160.[8]

<u>Accounting for Group A&B</u>

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

<u>Accounting for Group A-B</u>

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

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

Proponents of that view believe that the principles set out in IAS 12.52A/57A should apply not only to the parent company of the Group but also to other entities in the group. Therefore, if subsidiary B operates in a jurisdiction where income tax is payable only when profit is distributed then no income tax should be recognised before that moment. Furthermore, the proponents of that view believe that the legal structure of the group shall not have any impact on the accounting treatment. Therefore, regardless of whether the group consists of one legal entity (A&B) or two legal entities (A-B), they should recognise income tax at the same time, if they are otherwise identical and subject to the same taxation regime. Under this view no tax expense would be recognised until dividend payments on 31 March of the following year.

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

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

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

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

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

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

Application of View 2 would result in a different deferred tax accounting depending on whether the group consists of one or more legal entities. In case of one legal entity (A&B) no deferred tax would be recognised at year end. In case of more legal entities (A-B), no tax is recognised in respect of profits arisen in the parent but deferred tax is recognised in respect of profits generated in subsidiaries. As a result, two otherwise identical consolidation groups may have different profit and equity, depending on whether they consist of one or more legal entities and/or whether more profit is generated at the parent or subsidiaries level. It appears to be misleading to the users of the financial statements that two otherwise identical groups operating in the same tax regime and being subject to the same amounts of taxes payable could apply different deferred tax accounting and therefore show different profit and equity depending on their legal structure (although those differences in legal structure would not have any impact on actual amounts of taxes payable).

Questions to the Interpretations Committee

We have the following questions to the Interpretations Committee:

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

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