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STAFF PAPER

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IASB Meeting

Project	**IAS 12 *Income Taxes***
Paper topic	Accounting for income tax consequences of payments on, and issuing costs of, financial instruments classified as equity

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Introduction

1. The IFRS Interpretations Committee ('Interpretations Committee’) received a request to clarify an issue relating to the application of the requirements in IAS 12 *Income Taxes*. More specifically, the issue relates to where to present any income tax consequences of payments on, and issuing costs of, financial instruments classified as equity.

2. The Interpretations Committee discussed the issue in November 2015 and March 2016. The Interpretations Committee recommends that the Board address the issue by proposing an amendment to IAS 12. Such an amendment would clarify that the presentation requirements in paragraph 52B of IAS 12 apply to all payments on financial instruments classified as equity that are distributions of profits, and are not limited to the circumstances described in paragraph 52A of IAS 12 (ie circumstances in which different income tax rates apply to distributed and undistributed profits).

3. This paper is structured as follows:

   (a) background (paragraphs 5–9);

   (b) staff analysis (paragraphs 10–36);

   (c) questions for the Board; and

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(d) Appendix A—Assessment against the Interpretations Committee's agenda criteria.

4. Appendix B to this paper reproduces paragraphs 52A–52B, 57–58 and 61A of IAS 12 and paragraphs 35–35A of IAS 32 *Financial Instruments: Presentation*.

Background

The issue submitted

5. The issue submitted relates to the presentation of income tax relating to:

   (a) tax deductible payments on financial instruments classified as equity, for example, tax deductible payments to holders of perpetual bonds classified as equity; and

   (b) the costs of issuing such instruments.

6. Paragraph 35 of IAS 32 requires an entity to recognise directly in equity (a) distributions to holders of an equity instrument and (b) transaction costs of such an instrument. Paragraph 35A of IAS 32 goes on to require an entity to account for income tax relating to such distributions and costs applying IAS 12.

7. Paragraph 61A of IAS 12 requires an entity to recognise directly in equity any income tax relating to items that are recognised directly in equity. However, paragraph 52B of IAS 12 includes requirements on the income tax consequences of dividends. That paragraph requires an entity to recognise the income tax consequences of dividends in profit or loss, except to the extent that those tax consequences arise from transactions that an entity recognises outside profit or loss or from a business combination.

8. In the light of these requirements, the submitter had observed diversity in the application of the requirements in IAS 12 with respect to the presentation of income tax relating to tax deductible payments on, and the issuing costs of, financial instruments classified as equity as follows:

   (a) View A—Present income tax in profit or loss, because the requirements in paragraph 52B of IAS 12 would apply to income tax relating to tax

deductible payments on financial instruments classified as equity. The submitter notes that proponents of View A think that the tax deductions relating to such payments are equivalent to a lower rate of income tax being applied to distributed profits, which is one of the circumstances included in paragraph 52A of IAS 12 (reproduced in paragraph 19 of this paper). Consequently, they conclude that the requirements in paragraph 52B of IAS 12 apply to such tax consequences.

(b) View B—Present income tax directly in equity, because the transaction that gives rise to the income tax is recognised directly in equity. The introductory wording in paragraph 52B of IAS 12 (reproduced in paragraph 19 of this paper) refers to the circumstances described in paragraph 52A of IAS 12—circumstances in which different income tax rates apply to distributed and undistributed profits. Proponents of View B say that paragraph 52B of IAS 12 is not applicable in the circumstances described in the submission. This is because, in the fact pattern provided in the submission, there are neither two different tax rates for distributed and undistributed profits nor does an entity receive tax refunds from the tax deductible payments described in the submission.

Summary of feedback received from outreach activities as reported to the Interpretations Committee in November 2015[1]

9. The feedback received from our outreach activities can be summarised as follows:

   (a) about half of the respondents noted that the issue is common. Of those respondents, about half noted that the predominant accounting that they had observed was presenting the income tax consequences described in the submission in equity.

   (b) about one-third of the respondents said that there is at least some diversity in practice. Some of those respondents were of the view that some form of

[1] For details, see Agenda Paper 8 for the Interpretations Committee's meeting in November 2015. The outreach was conducted with members of the International Forum of Accounting Standard-Setters, securities regulators, and the global IFRS technical teams of the large accounting firms.

clarification would be helpful because the requirements in IAS 12 are unclear with respect to this issue.

Staff analysis

Summary of staff analysis presented to the Interpretations Committee[2]

Tax consequences of transaction costs on financial instruments classified as equity

10. Paragraph 35 of IAS 32 requires an entity to account for transaction costs of an equity transaction as a deduction from equity. Because the issuing costs described in the submission relate to financial instruments classified as equity, an entity recognises such costs directly in equity, and not in profit or loss.

11. Paragraph 57 of IAS 12 requires an entity to present income tax consistently with the transactions or events that give rise to that income tax. Consequently, an entity recognises directly in equity any income tax consequences arising from the costs of issuing financial instruments classified as equity.

Tax consequences of payments on financial instruments classified as equity

Consistency between the requirements in paragraph 52B and those in paragraphs 57, 58 and 61A of IAS 12

12. At the Interpretations Committee's meeting in November 2015, a concern was raised that the presentation requirements in paragraph 52B of IAS 12 could be viewed as being inconsistent with the general presentation principle in paragraph 57 and the related presentation requirements in paragraphs 58 and 61A of IAS 12.

13. This concern arises because:

    (a) the general presentation principle requires an entity to present income tax in the same manner as the presentation of the transactions or events that give rise to that income tax; however,

[2] For details, see Agenda Paper 8 and Agenda Paper 5 discussed at the Interpretations Committee's meetings in November 2015 and March 2016, respectively.

(b) depending on the particular circumstances, paragraph 52B of IAS 12 can require an entity to recognise the income tax consequences of dividends in profit or loss, even though the dividends themselves are recognised directly in equity.

14. In our view, the requirements in paragraph 52B of IAS 12 are not an exception to the general presentation principle in paragraph 57 of IAS 12 and related presentation requirements in paragraphs 58 and 61A of IAS 12. We consider paragraph 52B of IAS 12 to be an interpretation of that principle and the related requirements, but only in the context of presenting the income tax consequences of dividends. This view is aligned with the wording of paragraph 52B of IAS 12 itself, which states that 'the income tax consequences of dividends are recognised in profit or loss for the period *as required by paragraph 58*…' (emphasis added).

15. Paragraph 52B of IAS 12 specifies that:

(a) an entity links the income tax consequences of dividends to the transactions or events that have generated distributable profits; and

(b) the entity applies the presentation requirements in paragraph 58 of IAS 12 considering the transactions or events that the entity identifies in step (a) above, and not considering the dividends themselves.

16. As a consequence, if an entity recognises the transactions or events that generated distributable profits in profit or loss, then the entity also recognises the tax consequences of the related dividends in profit or loss. Similarly, if the entity recognises the transactions or events that generated distributable profits outside profit or loss, for example, directly in equity or other comprehensive income, then the entity recognises the tax consequences of the related dividends in a way that is consistent with the recognition of those transactions or events.

17. We think that our view is consistent with the Board's observations in paragraph BC33C of IAS 32, which states:

> […] the Board observed that the income tax consequences of distributions to holders of an equity instrument are recognised in profit or loss in accordance with paragraph 52B of IAS 12. Consequently, to the extent that

> the distribution relates to income arising from a transaction that was originally recognised in profit or loss, the income tax on the distribution should be recognised in profit or loss. However, if the distribution relates to income or to a transaction that was originally recognised in other comprehensive income or equity, the entity should apply the exception in paragraph 58(a) of IAS 12, and recognise the income tax consequences of the distribution outside of profit or loss. […]

18. On the basis of this analysis, we are of the view that the presentation requirements in paragraph 52B of IAS 12, relating to the income tax consequences of dividends, are consistent with the requirements in paragraphs 57, 58 and 61A of IAS 12.

Scope of transactions to which paragraph 52B of IAS 12 applies

19. Paragraphs 52A and 52B of IAS 12 state the following (emphasis added):

> 52A In some jurisdictions, income taxes are payable <u>*at a higher or lower rate*</u> 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.
>
> 52B <u>*In the circumstances described in paragraph 52A*</u>, the income tax consequences of dividends are recognised when a liability to pay the dividend is recognised. The income tax consequences of dividends are more directly linked to past transactions or events than to distributions to owners. Therefore, the income tax consequences of dividends are recognised in profit or loss for the period as required by paragraph 58 except to the extent that the income tax consequences of dividends

arise from the circumstances described in paragraph 58(a) and (b).

20. Some might interpret the requirements in paragraphs 52A and 52B of IAS 12 to say that the presentation requirements in paragraph 52B of IAS 12 apply only in circumstances in which there are different tax rates for distributed and undistributed profits.

21. In contrast, if the second and third sentences of paragraph 52B of IAS 12 are read in isolation, they would seem to suggest that the applicability of the presentation requirements in that paragraph are not limited to the circumstances described in paragraph 52A of IAS 12.

22. Paragraphs 52A and 52B were added to IAS 12 in 2000. The International Accounting Standards Committee (IASC) made the amendment in response to a question raised in circumstances in which different tax rates applied to distributed and undistributed profits. The IASC staff papers supporting the development of the requirements did not explain whether the presentation requirements in paragraph 52B were intended to apply only in the circumstances described in paragraph 52A of IAS 12.

23. Nonetheless, we think that the circumstances to which paragraph 52B of IAS 12 applies should not be limited to only those described in paragraph 52A of IAS 12. This is because:

    (a) paragraph 52B requires an entity to link the income tax consequences of dividends to the transactions or events that generated distributable profits, and then apply the requirements in paragraph 58 of IAS 12 in determining how to present those income tax consequences (as explained in paragraphs 15–16 of this paper).

    (b) in this respect, we think that it is irrelevant how the income tax consequences arise from dividends. In other words, we do not think that it matters whether such income tax consequences arise because of (i) different tax rates for distributed and undistributed profits or (ii) the deductibility of the dividends for tax purposes. This is because, in both cases, the income tax consequences arise from the distribution of profits.

(c) in general, we think that linking the presentation of income tax to the way in which the tax (ie different tax rates rather than different deductibility) would lead to arbitrary results and a lack of comparability across entities in different tax jurisdictions. Different tax jurisdictions choose different methods of giving tax relief. What matters is the resulting tax effect, not the mechanism.

24. It is also worthwhile noting that paragraph BC33C of IAS 32 (reproduced in paragraph 17 of this paper) does not limit the Board's observation regarding the application of paragraph 52B to only those circumstances described in paragraph 52A of IAS 12.

Does paragraph 52B apply to the income tax consequences of tax deductible payments on financial instruments classified as equity?

25. We are of the view that paragraph 52B of IAS 12 should apply to the presentation of any income tax consequences of dividends. Accordingly, an entity would assess whether to apply the requirements in paragraph 52B to payments on financial instruments classified as equity by determining whether those payments would be considered to be dividends.

26. IFRS 9 defines dividends as 'distributions of profits to holders of equity instruments in proportion to their holdings of a particular class of capital'. Consequently, in our view, the presentation requirements in paragraph 52B of IAS 12 should apply to the income tax consequences of all distributions of profit to holders of equity instruments. In this respect, we think that determining whether a payment on a financial instrument classified as equity is a distribution of profit may require judgement.

27. Accordingly, even though we have concluded that an entity would apply paragraph 52B of IAS 12 to income tax arising from all distributions of profits, the entity may need to apply judgement to determine whether payments on financial instruments classified as equity are distributions of profit.

Summary of Interpretations Committee's discussions

28. The following is a summary of the Interpretations Committee's discussions at its meetings in November 2015 and March 2016:

    (a) no one disagreed with the staff analysis, set out in paragraphs 10–11 of this paper, that an entity presents directly in equity income tax arising from the costs of issuing financial instruments classified as equity.

    (b) there was general agreement with the staff recommendation to propose an amendment to IAS 12 to clarify that the presentation requirements in paragraph 52B apply beyond the circumstances described in paragraph 52A of IAS 12. However, one Interpretations Committee member disagreed with the proposal. This is because, in his view, paragraph 52B as currently worded can be read to apply beyond the circumstances described in paragraph 52A of IAS 12.

    (c) the Interpretations Committee discussed the distinction between what is, and is not, a distribution of profits. Interpretations Committee members observed that the key question in applying the proposed amendment would be to determine when a payment on a financial instrument classified as equity is a distribution of profits. That assessment would often require judgement. Although one Interpretations Committee member suggested that the amendment might include indicators to help entities make that distinction, the Interpretations Committee did not recommend that the amendment address how to distinguish between what is, and is not, a distribution of profits. If the amendment were to define or describe a distribution of profits, it would be more than an amendment to IAS 12.

Distinction between what is, and is not, a distribution of profits

29. We agree with the Interpretations Committee's observation that the key question in assessing where to present income taxes arising from payments on financial instruments classified as equity is to determine when the payments are distributions of profits. This is because:

(a) if the payments are distributions of profits, then paragraph 52B of IAS 12 applies to any income tax consequences of such payments.

(b) if the payments are not distributions of profits, then the entity presents any income tax consequences of such payments directly in equity, applying paragraphs 57 and 61A of IAS 12.

30. We also acknowledge that an entity may need to apply judgement to determine whether such payments are distributions of profits. Nonetheless, we recommend that the proposed amendment does not address this aspect for the following reasons:

(a) Including indicators or requirements that describe distributions of profits would not be an amendment to IAS 12. Rather, it would affect several other Standards and Interpretations including IAS 32, IFRS 9, IFRIC 17 *Distributions of Non-cash Assets to Owners*, to name but a few. Because of this, we think there would be a high risk of unintended consequences if we were to attempt to define or describe distributions of profits.

(b) The proposed amendment does not create any lack of clarity about what is, and is not, a distribution of profits. The proposed amendment merely clarifies that the presentation requirements in paragraph 52B of IAS 12 apply beyond the circumstances described in paragraph 52A of IAS 12.

(c) Although there is no requirement for an entity that *pays* a distribution to distinguish distributions of profits from others, there is a requirement in IFRS 9 *Financial Instruments* for an entity that *receives* a distribution to determine whether it is a distribution of profits. IFRS 9 does not include any detailed requirements on how to make that determination. Paragraph B5.7.1 of IFRS 9 states:

> 'Dividends on such investments are recognised in profit or loss in accordance with paragraph 5.7.6 unless the dividend clearly represents a recovery of part of the cost of the investment.'

31. In saying that, we are aware of concerns that some might interpret the proposed amendment to IAS 12 to say that an entity would present income tax arising from

all payments on instruments classified as equity in profit or loss, and not directly in equity. This concern was raised in the context of financial instruments classified as equity that, nonetheless, have payment terms that are not directly related to the entity's generation of profits.

32. To address this concern, we think it would be helpful to mention in the basis for conclusions that the Board does not intend the proposed amendment to be read to say that an entity presents in profit or loss income tax arising from all payments on financial instruments classified as equity. Instead, an entity needs to apply judgement in determining whether payments on such instruments are distributions of profits, and thus whether paragraph 52B applies.

Transition requirements

33. We recommend application of the proposed amendment retrospectively applying the general transition requirements in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. We think that implementing the proposed amendment would not be costly, and see no reason to suggest alternative transition requirements. We also propose that the Board permit earlier application.

Consequential amendments

34. We have not identified any consequential amendments to other Standards that would be triggered by the proposed amendment. This includes IFRS 1 *First-time Adoption of International Financial Reporting Standards*—the proposed amendment is not expected to have any particular effect on first-time adopters.

Form of the amendment and what it should address

35. We recommend that the Board propose an amendment to IAS 12 as an Annual Improvement. The amendment would clarify the circumstances in which the presentation requirements in paragraph 52B of IAS 12 apply. We note that the clarifying nature of the proposed amendment fits the description of an Annual Improvement (refer to Appendix A to this paper for further information).

36. The submission relates to the presentation of income tax arising from payments on financial instruments classified as equity as well as the costs of issuing such instruments. However, with respect to issuing costs, the requirements in IFRS Standards provide an adequate basis for an entity to determine how to present any associated income tax. Consequently, we recommend that the proposed amendment does not address the presentation of income tax arising from issuing costs.

Questions for the Board

Questions for the Board
1. Does the Board agree with the proposed amendment to IAS 12, which would clarify that the presentation requirements in paragraph 52B of IAS 12 apply beyond the circumstances described in paragraph 52A of IAS 12, ie an entity would apply the presentation requirements in paragraph 52B to any income tax consequences of dividends? 2. Does the Board agree with the staff recommendation that such a proposal be made as an Annual Improvement? 3. Does the Board agree with the staff recommendation that the proposed amendment does not address the distinction between what is, and is not, a distribution of profits? 4. Does the Board agree that an entity should apply the proposed amendment retrospectively and earlier application should be permitted?

Appendix A—Assessment against the Interpretations Committee's agenda criteria

A1. We have assessed this issue against the agenda criteria of the current *Due Process Handbook* as follows:

Agenda criteria	
We should address issues (5.16):	
that have widespread effect and have, or are expected to have, a material effect on those affected.	**Yes.** According to the feedback received from outreach activities, the issue is common in a number of jurisdictions. Because the issue relates to income tax arising from dividends, the effect is not limited to those jurisdictions in which there are different tax rates for distributed and undistributed profits.
…where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods.	**Yes.** We think that a clarification with respect to this issue would promote consistent application of the requirements in paragraph 52B of IAS 12 in circumstances in which income tax arises from dividends.
…that can be resolved efficiently within the confines of existing Standards and the *Conceptual Framework for Financial Reporting*. Is the issue sufficiently narrow in scope that the Interpretations Committee can address it in an efficient manner, but not so narrow that it is not cost-effective for it to undertake the due process that would be required when making changes to IFRS (5.17)?	**Yes.** We think that an amendment can resolve the issue efficiently within the confines of existing Standards because the clarification relates only to the presentation of income tax arising from dividends.
Will the solution developed by the Interpretations Committee be effective for a reasonable time period (5.21)? (The Interpretations Committee will not add an item to its agenda if the issue is being addressed in a forthcoming Standard and/or if a short-term improvement is not justified).	**Yes.** The issue is not being addressed in any current or planned Board project.
In addition to the implementation and maintenance criteria, an annual improvement should (6.11, 6.12):	
Replace unclear wording; Provide missing guidance; or Correct minor unintended consequences, oversights or conflict.	**Yes.** We think that an amendment would clarify the circumstances in which the presentation requirements in paragraph 52B of IAS 12 apply.
Not change an existing principle or propose a new principle.	**Yes.** We think that an amendment does not change an existing principle, nor does it relate to a new principle.

Agenda criteria	
Not be so fundamental that the IASB will have to meet several times to conclude (6.14).	**Yes.** We think that such an amendment would be a clarification of the circumstances in which the presentation requirements in paragraph 52B of IAS 12 apply. Consequently, we do not consider it to be so fundamental that the Board will have to meet several times to conclude.

Appendix B—Extracts from Standards

IAS 12 Income Taxes

52A 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.

52B In the circumstances described in paragraph 52A, the income tax consequences of dividends are recognised when a liability to pay the dividend is recognised. The income tax consequences of dividends are more directly linked to past transactions or events than to distributions to owners. Therefore, the income tax consequences of dividends are recognised in profit or loss for the period as required by paragraph 58 except to the extent that the income tax consequences of dividends arise from the circumstances described in paragraph 58(a) and (b).

57 Accounting for the current and deferred tax effects of a transaction or other event is consistent with the accounting for the transaction or event itself. Paragraphs 58 to 68C implement this principle.

58 Current and deferred tax shall be recognised as income or an expense and included in profit or loss for the period, except to the extent that the tax arises from:

(a) a transaction or event which is recognised, in the same or a different period, outside profit or loss, either in other comprehensive income or directly in equity (see paragraphs 61A–65); or

(b) a business combination (other than the acquisition by an investment entity, as defined in IFRS 10 *Consolidated Financial Statements*, of a subsidiary that is required to be

measured at fair value through profit or loss) (see paragraphs 66–68).

61A **Current tax and deferred tax shall be recognised outside profit or loss if the tax relates to items that are recognised, in the same or a different period, outside profit or loss. Therefore, current tax and deferred tax that relates to items that are recognised, in the same or a different period:**

(a) in other comprehensive income, shall be recognised in other comprehensive income (see paragraph 62).

(b) directly in equity, shall be recognised directly in equity (see paragraph 62A).

IAS 32 Financial Instruments: Presentation

35 Interest, dividends, losses and gains relating to a financial instrument or a component that is a financial liability shall be recognised as income or expense in profit or loss. Distributions to holders of an equity instrument shall be recognised by the entity directly in equity. Transaction costs of an equity transaction shall be accounted for as a deduction from equity.

35A Income tax relating to distributions to holders of an equity instrument and to transaction costs of an equity transaction shall be accounted for in accordance with IAS 12 *Income Taxes*.