STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	IAS 12 *Income Taxes*		
Paper topic	Impact of an internal reorganisation on deferred tax amounts related to goodwill		
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Introduction

1. In June 2013, the IFRS Interpretations Committee ('the Interpretations Committee') received a request for guidance on the calculation of deferred tax as a consequence of an internal reorganisation of an entity. In particular, the request describes a circumstance in which:
   (a) an entity (Entity H) transfers a group of assets, including the related goodwill, that meets the definition of a business in IFRS 3 *Business Combinations* to its new wholly-owned subsidiary (Subsidiary A); however,
   (b) for tax purposes, the goodwill is not transferred to Subsidiary A.
2. In this circumstance, the submitter asks the Interpretations Committee to clarify how to calculate deferred tax assets and deferred tax liabilities in Entity H's consolidated financial statements.
3. This Agenda Paper is organised as follows:
   (a) Summary of the issue
   (b) Summary of outreach conducted
   (c) Staff analysis

(d) Agenda criteria assessment

(e) Staff recommendation

(f) Appendix A–Proposed wording for tentative agenda decision

(g) Appendix B–Numerical example

(h) Appendix C–Submission.

Summary of the issue[1]

4. A parent entity (Entity H) recognised goodwill that had resulted from an acquired group of assets (Business C) that meets the definition of a business in IFRS 3 (in other words, this was a business combination that involved acquiring the business directly, rather than one in which the shares of the entity in which the business operated were acquired). The submitter assumed that on the acquisition date, the carrying amount of the goodwill ('the **goodwill from Business D**') equals its tax base. In subsequent periods, Entity H has recognised a deferred tax liability because the goodwill from Business D is deductible for tax purposes over 18 years.

5. Entity H effects an internal reorganisation in which it sets up a new wholly-owned subsidiary (Subsidiary A). Entity H transfers Business D, including the goodwill from Business D, to Subsidiary A. In its separate financial statements, Entity H accounts for the transaction of this internal reorganisation by recording an investment in Subsidiary A at the carrying amounts of the assets and liabilities of Business D (ie so-called 'predecessor method'). For tax purposes, the goodwill from Business D is not transferred to Subsidiary A under local tax laws. It remains an asset of Entity H and continues to be amortised for tax purposes over the remaining period. This treatment would continue to apply even if Subsidiary A (or Business D) was

[1] For the convenience of understanding, we have included a numerical example in Appendix B.

disposed of or was impaired. In addition, the tax base of assets and liabilities is determined by reference to the tax returns of each entity in the group[2].

6. According to the submitter, as a result of this transaction, Entity H would prepare its separate financial statements and Subsidiary A prepares its **financial statements** as follows:

   (a) Entity H derecognises the assets and liabilities of Business D including the goodwill and recognises the investment in Subsidiary A;

   (b) Entity H derecognises the previously recognised deferred tax liability because the previous taxable temporary difference has now become a deductible temporary difference;

   (c) in replacement, Entity H recognises a deferred tax asset (assuming that the recoverability criteria for recognition of deferred tax assets in IAS 12 *Income Taxes* are met)[3].

   (d) As for Subsidiary A, it recognises the assets and liabilities of Business D including the goodwill; and

   (e) Subsidiary A applies the initial recognition exemption in paragraph 15(a) of IAS 12[4] and, therefore, does not recognise a deferred tax liability, although there is a temporary difference between the amount of the goodwill from Business D transferred from Entity H and its tax base of nil.

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[2] Furthermore, under local tax laws, a participation exemption rule ('PEX') exists according to which if Entity H sold its investment in Subsidiary A, it would pay tax at a rate significantly lower (only 5 per cent of the gain would be taxed at the corporate tax rate of 33 per cent, the remaining 95 per cent being tax-exempt) than it would if it sold Business D directly (in which case the corporate tax rate would apply to the full amount of the gain).

[3] This is because of the deductible temporary difference between the carrying amount of the goodwill, which is zero, and the remaining tax base of the goodwill.

[4] The submitter does not provide reasons why the initial recognition exemption in paragraph 15(a) of IAS 12 applies.

7. The submitter asks how, in this situation, Entity H should account for deferred tax assets and deferred tax liabilities in its **consolidated financial statements**[5].

8. The submitter observes the following two views.

View 1 (the submitter's view)

(a) the transaction of the internal reorganisation has the effect of de-linking accounting goodwill from tax goodwill;

(b) as a result, the accounting treatments in the separate financial statements of Entity H and Subsidiary A should be retained in Entity H's consolidated financial statements so that:

(i) Entity H derecognises the previously recognised deferred tax liability. In replacement, it recognises a deferred tax asset on the temporary difference between the carrying amount of the goodwill from Business D, which is zero, and the remaining tax base of the goodwill; and

(ii) it does not recognise a deferred tax liability although there is a temporary difference between the amount of the goodwill from Business D transferred to Subsidiary A and its tax base of nil in the Subsidiary A's separate financial statements. This is because it applies the initial recognition exemption in paragraph 15 of IAS 12; and

(c) in addition, it should recognise a deferred tax liability on the temporary difference between the carrying amount of the investment in Subsidiary A and its tax basis (ie the temporary difference is equal to the difference between the amount of the goodwill from Business D transferred to Subsidiary A and its tax base of nil in Subsidiary A's separate financial statement) unless the criteria in paragraph 39 of IAS 12 are met.

[5] Therefore, this paper does not address the case of separate financial statements and individual financial statements.

View 2 (alternative view)

(a) the transaction of the internal reorganisation does not trigger any change relating to the recognition of deferred tax assets and deferred tax liabilities;

(b) temporary differences should be determined by comparing the consolidated carrying amount of assets and liabilities with their appropriate tax bases, regardless of the entity that holds the item and the entity that holds the tax base; and

(c) as a result, Entity H should continue to recognise the deferred tax liability on the temporary difference between the carrying amount of the goodwill from Business D, which is transferred to Subsidiary A, and the remaining tax base of the goodwill from Business D that has been applied in the tax return of Entity H.

Summary of outreach conducted

9. We requested information from the International Forum of Accounting Standard-Setters (IFASS) and securities regulators to help us to assess the issues against the Interpretations Committee's agenda criteria. Specifically, we asked:

(a) **(Question 1)** Is the fact pattern described in the submission common or relevant in your jurisdiction? If yes, please provide us with qualitative or quantitative information about how common it is.

(b) **(Question 2)** If you answered yes to Q1, what is the prevalent approach in your jurisdiction to account for deferred tax assets and deferred tax liabilities and why?

(c) **(Question 3)** Do you see any diversity in practice in that accounting? If so, please explain how and why the accounting is diversified.

10. We received thirteen responses from the members of IFASS. The breakdown from IFASS is as follows:

Geographical area	Number of responses
Asia-Oceania	6
Europe	3
Latin America (including Mexico)	2
North America	1
Africa	1
	13

11. With respect to Question 1, all respondents stated that the issue is not common in their jurisdictions. However, one jurisdiction said that they had observed similar fact patterns.

12. With respect to Question 2, although there are no jurisdictions where the issue is common, three respondents said that they prefer View 2 (alternative view). One of them argued for View 2 because (1) they think that no business combination has occurred at group level and no initial recognition exemption applies, because the goodwill existed in the group before the reorganisation; consequently, the reorganisation should not change the deferred tax number.

13. With regard to Question 3, one respondent said that there might be some diversity in practice.

14. We also received three responses from regulators. Two regulators said that the issue is not common, and one regulator said that the issue is common in a single jurisdiction.

Staff analysis

Analysis 1: Interpretation of paragraph 11 of IAS 12

15. We note that paragraph 11 of IAS 12 describes how temporary differences should be determined in consolidated financial statements. Paragraph 11 of IAS 12 states that:

> 11 In consolidated financial statements, **temporary differences** are determined by **comparing the carrying amounts of assets and liabilities in the consolidated financial statements with the appropriate tax base**. The tax base is determined by reference to a consolidated tax return in those jurisdictions in which such a return is filed. **In other jurisdictions, the tax base is determined by reference to the tax returns of each entity in the group.** (emphasis added)

16. According to paragraph 11 of IAS 12, the process of determining temporary differences would be as follows:

    (a) identify how the tax return is filed (ie whether it is filed on a consolidated group basis or on a separate entity basis);

    (b) if the tax return is filed on a separate entity basis, the appropriate tax base is determined on a separate entity basis; and

    (c) compare the (appropriate) tax base of each entity with the carrying amounts of assets and liabilities in the consolidated financial statements.

17. The submitter stated that the tax base of assets and liabilities is determined by reference to the tax returns of each entity in the group. This implies in the submitter’s case that Entity H and Subsidiary A file their tax returns respectively and therefore each determines its own appropriate tax base. Accordingly, with regard to the goodwill from Business D, there would be two separate tax bases, one for Entity H and the other for Subsidiary A.

18. Consequently, we think that (1) Entity H would compare the carrying amount of the goodwill from Business D, which is zero, with its tax base in Entity H and (2) Subsidiary A would compare the carrying amount of the goodwill from Business D, which is transferred from Entity H, with its tax base in Subsidiary A, which is nil. This means that in consolidated financial statements, temporary differences would be determined by Entity H and Subsidiary A separately in accordance with paragraph 11 of IAS 12.

19. On the basis of the analysis above, we think that **View 2 would not be appropriate**. This is because View 2 only considers the tax base of Entity H and compares that tax base with the carrying amount of the goodwill from Business D that Subsidiary A recognises.

20. Consequently, we note that there would be three temporary differences to consider in the submitter's case. They are:

    (a) from the perspective of Entity H, the temporary difference between the tax base of the goodwill from Business D and its carrying amount of zero ('**temporary difference A**');

    (b) from the perspective of Subsidiary A, the temporary difference between the tax base of the goodwill from Business D, which is zero, and the carrying amount of the goodwill from Business D that Subsidiary A recognises ('**temporary difference B**'); and

    (c) the so-called 'outside basis difference': the temporary difference between the tax base of the Entity H's investment in Subsidiary A and the carrying amount of that investment (namely, the net assets of Subsidiary A in Entity H's consolidated financial statements;) ('**temporary difference C**').

21. In the following analyses, we assess whether and how deferred tax should be recognised on these three temporary differences in Entity H's consolidated financial statements.

Analysis 2: the temporary difference in Entity H's tax jurisdiction ('temporary difference A') and the temporary difference in Subsidiary A's tax jurisdiction ('temporary difference B')

22. We note that:

    (a) the temporary difference in Entity H's tax jurisdiction between the tax base of the goodwill from Business D and its carrying amount of zero ('temporary difference A') is a deductible difference; and

    (b) the temporary difference in Subsidiary A's tax jurisdiction between the tax base of the goodwill from Business D, which is zero, and the carrying amount of the goodwill from Business D that Subsidiary A recognises ('temporary difference B') is a taxable difference.

23. Paragraphs 15 and 24 of IAS 12 set out the principles for recognising a deferred tax asset for deductible temporary differences and a deferred tax liability for taxable temporary differences:

    > 15 A deferred tax liability shall be recognised for all taxable temporary differences, **except to the extent that the deferred tax liability arises from:**
    >
    > **(a) the initial recognition of goodwill; or**
    >
    > **(b) the initial recognition of an asset or liability in a transaction** which:
    >
    > (i) is not a business combination; and
    >
    > (ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).
    >
    > However, for taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, a deferred tax liability shall be recognised in accordance with paragraph 39. (emphasis added)

> 24 A deferred tax asset shall be recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised, unless the deferred tax asset arises from the **initial recognition of an asset or liability in a transaction** that:
>
> (a) is not a business combination; and
>
> (b) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).
>
> However, for deductible temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, a deferred tax asset shall be recognised in accordance with paragraph 44. (emphasis added)

24. Paragraphs 15 and 24 of IAS 12 provide exceptions from recognising a deferred tax liability and a deferred tax asset. Paragraph 15 of IAS 12 states that a deferred tax liability is not recognised when it arises from (1) the initial recognition of goodwill or (2) the initial recognition of an asset or liability in a transaction, if conditions (i) and (ii) are met. Paragraph 24 of IAS 12 states that a deferred tax asset is not recognised when it arises from the initial recognition of an asset or liability in a transaction, if conditions (a) and (b) are met.

25. We think that those exceptions in paragraphs 15 and 24 of IAS 12 would not apply to the submitter's case because from the perspective of the consolidated financial statements, the transfer of the goodwill from Business D (ie from Entity H to Subsidiary A) does not trigger either the initial recognition of goodwill' or 'the initial recognition of an asset or liability in a transaction'.

26. Consequently, we think that:

(a) a deferred tax asset for temporary difference A[6] should be recognised in accordance with paragraph 24 of IAS 12, provided that other criteria (ie the recoverability criteria) for recognition of deferred tax assets in IAS 12 are met; and

(b) a deferred tax liability for temporary difference B should be recognised in accordance with paragraph 15 of IAS 12.

Analysis 3: the so-called 'outside basis difference': the temporary difference between the tax base of Entity H's investment in Subsidiary A and the carrying amount of that investment (namely, the net assets of Subsidiary A in Entity H's consolidated financial statements) ('temporary difference C')

27. The submitter said that according to View 1, a deferred tax liability should be recognised on the temporary difference between the tax base of the investment in Subsidiary A and the carrying amount of the investment in Subsidiary A (namely, the net assets of Subsidiary A in Entity H's consolidated financial statements; the so-called 'outside basis difference') unless the criteria in paragraph 39 of IAS 12 are met. This is because, according to the submitter, this temporary difference is equal to the difference between the initial carrying amount of the goodwill from Business D in Subsidiary A's individual financial statements and its tax base of nil in Subsidiary A's tax jurisdiction.

28. Paragraphs 38 and 39 of IAS 12 set out the requirements for this type of temporary difference. These two paragraphs are as follows:

> 38 Temporary differences arise when the carrying amount of investments in subsidiaries, branches and associates or interests in joint arrangements (namely the parent or investor's share of the net assets of the subsidiary, branch, associate or

[6] We note that Entity H records an investment in Subsidiary A at the carrying amounts of the assets and liabilities of Business D (ie so-called 'predecessor method'). This means that no other new temporary difference would arise at the time of the internal reorganisation.

investee, including the carrying amount of goodwill) becomes different from the tax base (which is often cost) of the investment or interest. Such differences may arise in a number of different circumstances, for example:

(a) the existence of undistributed profits of subsidiaries, branches, associates and joint arrangements;

(b) changes in foreign exchange rates when a parent and its subsidiary are based in different countries; and

(c) a reduction in the carrying amount of an investment in an associate to its recoverable amount.

In consolidated financial statements, the temporary difference may be different from the temporary difference associated with that investment in the parent's separate financial statements if the parent carries the investment in its separate financial statements at cost or revalued amount.

39 An entity shall recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, except to the extent that both of the following conditions are satisfied:

(a) the parent, investor, joint venturer or joint operator 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.

29. We note that there may be temporary difference between the carrying amount of the investment in Subsidiary A and the tax base of that investment. If that is the case, such temporary difference would constitute the temporary differences described in paragraph 38 and 39 of IAS 12 and therefore a

deferred tax asset or liability would be recognised[7]. Otherwise, temporary differences (ie 'outside basis differences') described in paragraphs 38 and 39 of IAS 12 would be triggered only by post-acquisition changes in either the net assets of Subsidiary A or in the tax base in Entity H's tax jurisdiction of its investment in Subsidiary A.

Summary of staff analysis

30. On the basis of the analyses above, the staff view can be summarised as follows.

31. Entity H and Subsidiary A determine their tax bases separately because each entity files its tax return respectively. Accordingly, we identify three temporary differences:

    (a) in Entity H's tax jurisdiction, the temporary difference between the tax base of the goodwill from Business D and its carrying amount of zero ('**temporary difference A**');

    (b) in Subsidiary A's tax jurisdiction, the temporary difference between the tax base of the goodwill from Business D, which is zero, and the carrying amount of that goodwill in Subsidiary A's financial statemements ('**temporary difference B**'); and

    (c) the so-called 'outside basis difference': the temporary difference between the tax base in Entity H's tax jurisdiction of the investment in Subsidiary A and the carrying amount in Entity H's consolidated financial statements of the investment in Subsidiary A (namely, the net assets of Subsidiary A in Entity H's consolidated financial statements;) ('**temporary difference C**').

32. We think that the exceptions to recognising a deferred tax liability and a deferred tax asset described in paragraphs 15 and 24 of IAS 12 do not apply to

[7] The recognition of temporary difference C would be subject to the limitations and exceptions applying to the recognition of a deferred tax asset (in accordance with paragraph 44 of IAS 12) and a deferred tax liability (in accordance with paragraph 39 of IAS 12).

the transfer of the goodwill from Business D (ie from Entity H to Subsidiary A). This is because from the perspective of consolidated financial statements, such transfer would not trigger 'the initial recognition of goodwill' or 'the initial recognition of an asset or liability', which are the conditions of those exceptions.

33. Consequently, we think that a deferred tax asset for temporary difference A and a deferred tax liability for temporary difference B should be recognised in accordance with paragraphs 15 and 24 of IAS 12.

34. As for temporary difference C, If there is a temporary difference between the carrying amount of the investment in Subsidiary A and the tax base of the investment, it would be a so-called 'outside basis difference'; and therefore a deferred tax asset or liability for such temporary difference would be recognised subject to the limitations and exceptions applying to the recognition of a deferred tax asset (in accordance with paragraph 44 of IAS 12) and a deferred tax liability (in accordance with paragraph 39 of IAS 12).

Question 1 for the Interpretations Committee

1. Does the Interpretations Committee agree with the staff analysis that:

(a) where entities in the same consolidated group file separate tax returns, separate temporary differences will arise in those entities in accordance with paragraph 11 of IAS 12. Consequently, when preparing consolidated financial statements, deferred tax balances would be determined separately for those temporary differences, using the applicable tax rates for each entity's tax jurisdiction; and

(b) when calculating deferred tax amount for consolidated financial statements:

(i) the amount used as the carrying amount for an asset or liability is the amount included in the consolidated financial statements; and

(ii) therefore, the assessment of whether an asset or liability is being recognised for the first time is made from the perspective of the consolidated financial statements for the purpose of applying the initial recognition exemption described in paragraph 15 and 24 of IAS 12?

Agenda criteria assessment

35. The staff's assessment of the agenda criteria[8] is as follows:

Source of issue	
Issues could include: the identification of divergent practices that have emerged for accounting for particular transactions, cases of doubt about the appropriate accounting treatment for a particular circumstance or concerns expressed by investors about poorly specified disclosure requirements (5.14).	
Criteria	
We should address issues (5.16):	
that have widespread effect and have, or are expected to have, a material effect on those affected;	All respondents from IFASS to our outreach activity stated that the issue is not common and one securities regulator said that the issue is common in a single jurisdiction.
where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods; and	**No.** We think that the current Standards are clear on this issue. Consequently, we do not see diverse reporting on this issue.
that can be resolved efficiently within the confines of existing IFRSs and the *Conceptual Framework for Financial Reporting*.	**N/A**
In addition:	

[8] These criteria can be found in the *IASB and IFRS Interpretations Committee Due Process Handbook* as indicated in the paragraphs below.

Is the issue sufficiently narrow in scope that the Interpretations Committee can address this issue in an efficient manner, but not so narrow that it is not cost-effective for the Interpretations Committee to undertake the due process that would be required when making changes to IFRSs (5.17)?	**N/A**
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)..	**N/A**

Staff recommendation

36. On the basis of our analysis above, we recommend that the Interpretations Committee should not take this issue onto its agenda.

37. We have set out proposed wording for the tentative agenda decision in **Appendix A**.

Questions 2 and 3 for the Interpretations Committee
2. Does the Interpretations Committee agree with the staff recommendation that the Interpretations Committee should not take this issue onto its agenda? 3. Does the Interpretations Committee agree with the draft tentative agenda decision as set out in Appendix A?

Appendix A—Proposed wording for tentative agenda decision

A1. We propose the following wording for the tentative agenda decision.

IFRS 3 *Business Combinations*—Impact of an internal reorganisation on deferred tax amounts related to goodwill

The Interpretations Committee received a request for guidance on the calculation of deferred tax as a consequence of an internal reorganisation of an entity. In particular, the request describes a circumstance in which:

(a) an entity (Entity H) transfers a group of assets, including the related goodwill, that meets the definition of a business in IFRS 3 *Business Combinations* to its new wholly-owned subsidiary (Subsidiary A); however,

(b) for tax purposes, the goodwill is not transferred to Subsidiary A.

The submitter asked how Entity H should account for deferred tax assets and deferred tax liabilities in its consolidated financial statements.

The Interpretations Committee noted that where entities in the same consolidated group file separate tax returns, separate temporary differences will arise in those entities in accordance with paragraph 11 of IAS 12. Consequently, the Interpretations Committee noted that when an entity prepares its consolidated financial statements, deferred tax balances would be determined separately for those temporary differences, using the applicable tax rates for each entity's tax jurisdiction.

The Interpretations Committee also noted that when calculating deferred tax amount for consolidated financial statements,:

(a) the amount used as the carrying amount for an asset or liability is the amount included in the consolidated financial statements; and

(b) therefore, the assessment of whether an asset or liability is being recognised for the first time is made from the perspective of the consolidated financial statements for the purpose of applying the

initial recognition exemption described in paragraph 15 and 24 of IAS 12.

The Interpretations Committee considered that, in the light of its analysis, the existing IFRS requirements and guidance were sufficient and therefore, an Interpretation was not necessary. Consequently, the Interpretations Committee [decided] not to add this issue to its agenda.

Appendix B—Numerical example

The fact patterns below are based on the description in the section 'Summary of the issue' of this paper. Besides, we also assume 'additional fact patterns' as below.

Fact patterns

Transactions at 31 December 20X1:

- Entity H recognises goodwill that results from an acquired group of assets (Business D) that meets the definition of a business in IFRS 3.
- The carrying amount of the goodwill ('the goodwill from Business D') equals its tax base.

Transactions at 31 December 20X3:

- Entity H sets up a new wholly-owned subsidiary (Subsidiary A).
- Entity H transfers Business D including the goodwill from Business D to Subsidiary A.
- Under the tax law, the goodwill from Business D is not transferred to Subsidiary A.

Additional fact patterns

- The goodwill from Business D is tax deductible for 10 years[9].
- The carrying amount of the goodwill from Business D at 31 December 20X1, 31 December 20X2 and 31 December 20X3: CU100
- The tax base of the goodwill from Business D at 31 December 20X1: CU100
- Tax rate in Entity H's tax jurisdiction: 10%
- Tax rate in Subsidiary A's tax jurisdiction: 20%

Based on the fact patterns above, the following example illustrates how Entity H would calculate its deferred tax amount on the goodwill from Business D in its

[9] Although the submitter's case noted that the goodwill from Business D is tax deductible for 18 years, this example changed the duration to 10 years for the convenience of calculation.

consolidated financial statements. We do not consider deferred tax amount that could arise from temporary difference between the tax base of the Entity H's investment in Subsidiary A and the carrying amount of that investment (ie 'outside basis difference').

At 31 December 20X2, Entity H recognises a deferred tax liability on the goodwill from Business D in its consolidated financial statements.

	CU
The carrying amount of the goodwill from Business D	100
Tax base	90
Taxable (deductible) temporary difference	10
Deferred tax asset (liability) at the tax rate of 10%	(1)

Method 1: Entity H and Subsidiary A determine their tax bases respectively

At 31 December 20X3, following the set-up of Subsidiary A, Entity H calculates its deferred tax amount on the goodwill from Business D in its consolidated financial statements as follows.

In Entity H's tax jurisdiction,

	CU
The carrying amount of the goodwill from Business D	0
Tax base	80
Taxable (deductible) temporary difference	(80)
Deferred tax asset (liability) at the tax rate of 10%	8

In Subsidiary A's tax jurisdiction,

	CU
The carrying amount of the goodwill from Business D	100
Tax base	0
Taxable (deductible) temporary difference	100
Deferred tax asset (liability) at the tax rate of 20%	(20)

Method 2: Entity H uses a single tax base

At 31 December 20X3, following the setup of Subsidiary A, Entity H calculates its deferred tax amount on the goodwill from Business D in its consolidated financial statements as follows.

	CU
The carrying amount of the goodwill from Business D	100
Tax base	80
Taxable (deductible) temporary difference	20
Deferred tax asset (liability) at the tax rate of 10%[10]	(2)

[10] It might be debatable which tax rate (ie 10% or 20%) should be applied if Method 2 is applied. We do not discuss this point in this paper because we do not support Method 2. Besides, the submission does not address applicable tax rates when describing View 2 (alternative view).

Appendix C—Submission

Impact of an internal reorganization on deferred tax amounts related to goodwill

Background

Entity H, a parent entity, acquires a group of assets ("the Business") that meets the definition of a business in IFRS 3. The business combination results in the recognition of goodwill in the separate and consolidated financial statements of Entity H. The goodwill arising on the transaction is allocated to the Business. For simplification purposes, it is assumed that the carrying amounts of identifiable assets and liabilities acquired in the financial statements of Entity H are the same as their tax bases initially and subsequently.

In accordance with local tax laws, the resulting goodwill is deductible for tax purposes over 18 years. On the acquisition-date, the carrying amount of the goodwill equals its tax base. However, subsequently, a taxable temporary difference arises from the amortisation of goodwill for tax purposes only and is recognised as a deferred tax liability as required by IAS 12.21B.

In a subsequent period, Entity H effects an internal reorganization ("the Transaction". It sets up a new wholly-owned subsidiary (Subsidiary A). Entity H transfers the Business, including the related goodwill, to Subsidiary A. Under local tax laws, tax goodwill is not transferred to Subsidiary A. It remains an asset of Entity H and continues to be amortised for tax purposes over the remaining period. This treatment would continue to apply even if Subsidiary A (or the Business) was disposed of or was impaired.

For accounting purposes, the Transaction is accounted for at carrying amounts (or "predecessor method") in the separate financial statements of Entity H and Subsidiary A, in accordance with the Group entity's accounting method common control transactions.

As a result of the initial recognition exemption in IAS 12.15, no deferred tax liability is recognised in the separate financial statements of Subsidiary A relating to the goodwill transferred. While in relation to the goodwill in A's financial statements there is a temporary difference because goodwill is not tax deductible anymore.

The deferred tax liability previously recognised in the separate financial statements of Entity H, is derecognised because the previous taxable temporary difference has now become a deductible temporary difference. In replacement, the following temporary differences exist in those financial statements:

- Deductible temporary difference arising from the difference between the remaining tax base of the goodwill transferred and its accounting base of nil (for illustrative purposes, it is assumed that the IAS 12 recoverability criteria for recognition of deferred tax assets are met)
- Taxable temporary difference arising from the difference between the carrying amount of the investment in Subsidiary A and its tax base (in effect this difference equals the carrying amount of the goodwill that has a tax base of nil in Subsidiary A).

In this jurisdiction, the tax base of assets and liabilities is determined by reference to the tax returns of each entity in the group. Further, under local tax laws, a participation exemption rule ("PEX") exists according to which if Entity H sold its investment in Subsidiary A, it would pay tax at a rate significantly lower (only 5% of the gain would be taxed at the corporate tax rate of 33%, the remaining 95% being tax exempt) than it would if it sold the Business directly (in which case the corporate tax rate would apply to the full amount of the gain).

Question

In the consolidated financial statements of H, what are the consequences of the Transaction, if any, on deferred tax assets/liabilities?

Submitter's view

The Transaction has the effect of de-linking accounting goodwill from tax goodwill. Indeed, regardless whether the Business or Subsidiary A is sold (and consequently, accounting goodwill derecognised), from a tax perspective, goodwill will continue to exist and to be amortised.

Accordingly, while IAS 12.11 indicates that "in consolidated financial statements, temporary differences are determined by comparing the carrying amounts of assets and liabilities in the consolidated financial statements with the appropriate tax base… determined by reference to the tax returns of each entity in the group", in the present case the "appropriate tax base" of the accounting goodwill is nil (its tax base in the tax return of Subsidiary A). Conversely, the tax goodwill (that exists for tax purposes from the perspective of Entity H) does not have a corresponding accounting amount.

Therefore, the potential deferred tax consequences of the accounting goodwill must be assessed separately from those of the tax goodwill.

Accounting goodwill

Following the transfer, in application of the initial recognition exemption, Subsidiary A does not recognise a deferred tax liability for the goodwill "received" (that has a nil tax basis, from subsidiary A's perspective) and the previously recognised deferred tax liability is reversed. This treatment shall be retained in the consolidated financial statements for the following reasons:

1. There is no linkage between the accounting goodwill and the tax goodwill. As explained above, the "appropriate tax basis" of the accounting goodwill cannot be presumed to be the tax basis of goodwill in Entity H; and

2. The only remaining taxable temporary difference relates to Entity H's investment in Subsidiary A (see Additional consideration below).

Tax goodwill

The tax goodwill (i.e. the right to deduct goodwill amortisation for tax purposes) is a tax benefit available to Entity H. The resulting deferred tax asset recognised in Entity H's separate financial statements shall be retained in the consolidated financial statements. This is justified because, to the extent that the accounting goodwill and the tax goodwill are no longer linked, the tax goodwill does not have a corresponding accounting amount. As such, it represents one of those items contemplated in IAS 12.9 that have a tax base but are not recognised as assets and liabilities in the statement of financial position. As explained in that paragraph, such deductible temporary differences are recognised as deferred tax assets (to the extent they are recoverable).

Additional consideration

In its consolidated financial statements, Entity H will need to assess whether a deferred tax liability shall be recognised in respect to its investment in Subsidiary A in accordance with IAS 12.39 (a so-called "outside basis difference"). As noted above, following the transfer, there is a taxable temporary difference between the carrying amount of the investment in Subsidiary A and its tax basis. This difference is equal to the amount of the goodwill transferred for accounting purposes but not for tax purposes. Accordingly, a deferred tax liability will need to be recognised in the consolidated financial statements unless the criteria in IAS 12.39 are met. If a deferred tax liability is recognised, to the extent the entity intends to recover its investment through sale of Subsidiary A (rather than sale of the Business), the

measurement of the deferred tax liability would reflect the reduced tax rate available under the participation exemption rule.

Alternative view

The alternative view is that the Transaction does not trigger any changes in deferred tax assets and liabilities. Neither the accounting amount nor the tax base of goodwill is affected by the Transaction. Hence, those who hold the alternative view do not believe that the transaction should result in deferred tax consequences. The mere transfer of accounting goodwill to a different entity within a consolidated group does not mean that the link that previously existed between the accounting and tax goodwill no longer exists.

Further, those who hold the alternative view believe, by indicating in IAS

12.11 that "in consolidated financial statements, temporary differences are determined by comparing the carrying amounts of assets and liabilities in the consolidated financial statements with the appropriate tax base", IAS 12 establishes a holistic approach to the determination of temporary differences. Under such an approach, temporary differences are determined by comparing the consolidated carrying amount of assets and liabilities with their appropriate tax bases, regardless of the entity that holds the item and of the entity that holds the tax basis.

Reasons for the submission

In the absence of a pronouncement of the IFRS IC, IFRS issuers may follow one of the two views illustrated above. This will generate difference in practice. Moreover we believe that the issue meets the criteria for addition to the agenda of the IFRS IC:

1) The issue has the potential to be widespread

   a. While the fiscal regime that triggers the issue may not exist currently in many jurisdictions, such regimes could be implemented in the future;

   b. In the fiscal regime question, other preparers are evaluating similar transactions;

2) There is diverse interpretations of the appropriate treatment for such transactions

   a. Different audit firms have expressed different views with respect to the appropriate accounting for this issue;

b. The local regulator has expressed a view that is different from the view expressed by the majority of the audit firms that have been consulted;

3) The two views presented above result in very different accounting consequences. Hence, financial reporting would be improved through elimination of the diversity of views;

4) The issue is sufficiently narrow in scope to be capable of interpretation within the confines of IFRSs and the Conceptual Framework;

5) There is no current or planned work by the IASB that would address this issue.