IFRS

STAFF PAPER

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IFRS Interpretations Committee Meeting

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

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Introduction

1. The IFRS Interpretations Committee ('the 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 the presentation of any income tax consequences of payments on, and issuing costs of, financial instruments classified as equity (ie whether an entity should present these income tax consequences directly in equity or in profit or loss).

2. The Interpretations Committee discussed the issue in November 2015. At that meeting, the Interpretations Committee noted that the interaction between the requirements in paragraph 52B of IAS 12 and those in paragraphs 57, 58 and 61A of IAS 12 is unclear. Consequently, the Interpretations Committee decided to discuss this issue further, focussing in particular on the circumstances that the requirements in paragraphs 52A and 52B of IAS 12 are intended to capture.

3. The questions raised at the Interpretations Committee's meeting in November 2015 relate to the income tax consequences of payments on financial instruments classified as equity. There was no disagreement with the staff analysis that an entity presents income tax relating to the costs of issuing such instruments directly in equity because those costs are recognised directly in equity applying paragraph 35 of IAS 32 *Financial Instruments: Presentation*. Accordingly, this paper sets

out additional staff analysis regarding the income tax consequences of payments on financial instruments classified as equity.

4. This paper is structured as follows:

   (a) background;

   (b) staff analysis;

   (c) summary and staff recommendation; and

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

Background

The issue submitted

5. The issue submitted relates to the presentation of income tax relating to payments on financial instruments classified as equity when those payments are deductible for tax purposes (for example, tax deductible payments to holders of perpetual bonds classified as equity).

6. Paragraph 35 of IAS 32 requires an entity to recognise distributions to holders of an equity instrument directly in equity. Paragraph 35A of IAS 32 goes on to require an entity to account for income tax relating to such distributions 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 the payments described in the submission as follows:

   (a) View A—Present the 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 instruments classified as equity. The submitter notes that proponents of View A think that the tax deductions relating to the payments described in the submission are equivalent to a lower rate of income tax being applied to distributed profits (ie one of the circumstances included in paragraph 52A of IAS 12). Consequently, they conclude that the requirements in paragraph 52B of IAS 12 apply to such tax consequences.

   (b) View B—Present the 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—ie circumstances in which different income tax rates apply to distributed and undistributed profits. The submitter notes that proponents of View B think that paragraph 52B of IAS 12 is not applicable to the circumstance described in the submission because there are neither two different tax rates for distributed and undistributed profits nor tax refunds arising from the payments described in the submission.

The Interpretations Committee's discussions in November 2015

9. The following is a summary of the Interpretations Committee's discussion at its meeting in November 2015:

   (a) Some Interpretations Committee members thought that the presentation of income tax relating to the payments described in the submission would be expected to be the same as the presentation of any income tax consequences of dividends to which paragraph 52B of IAS 12 applies. This is because:

(i) from an accounting perspective, an entity recognises within equity the financial instruments described in the submission, including payments on such instruments, in the same way as ordinary shares and dividends on such shares; and

(ii) the payments on the financial instruments described in the submission often require the existence of distributable profits and/or can be made only if an entity first pays dividends to its ordinary shareholders.

(b) Although some Interpretations Committee members thought that paragraph 52B of IAS 12 might not apply to income tax relating to the payments described in the submission (on the grounds that the circumstance described does not involve different tax rates), they thought that an argument could easily be made to the contrary (on the grounds that the requirements in paragraph 52B apply generally to income tax relating to dividends). Consequently, they thought that it would be helpful to clarify whether paragraph 52B of IAS 12 is applicable in the circumstance described in the submission.

(c) Interpretation Committee members thought that the reference to paragraphs 58(a) and (b) of IAS 12 included within paragraph 52B of IAS 12 is confusing.

Summary of the outreach activities as reported in November 2015[1]

10. We received 16 responses. The feedback received 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.

[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.

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

Staff analysis

11. This section is divided into the following subsections:

    (a) Are the requirements in paragraph 52B consistent with those in paragraphs 57, 58 and 61A of IAS 12?

    (b) Do the presentation requirements in paragraph 52B apply only in those circumstances described in paragraph 52A of IAS 12?

    (c) Should the presentation requirements in paragraph 52B apply to the income tax consequences of dividends that arise in circumstances other than those described in paragraph 52A of IAS 12?

    (d) Does paragraph 52B apply to the income tax consequences of the payments described in the submission?

Are the requirements in paragraph 52B consistent with 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. We understand that 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,

    (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. We are of the view that paragraph 52B of IAS 12 specifies the following:

    (a) If dividends give rise to income tax consequences, an entity assesses the underlying transactions and events that generated distributable profits, and not the act of distributing profits itself (ie not the dividend transaction). In other words, an entity links the income tax consequences of dividends to the transactions or events that have generated distributable profits.

    (b) An 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 (eg 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.[2]

17. We think that our view is consistent with the Board's observations in paragraph BC33C of IAS 32. That paragraph explains the basis for an amendment made to

[2] An example of this would be when dividends relate to income that arises from changes in the fair value of investments in equity instruments, which an entity chooses to recognise in other comprehensive income (OCI) applying IFRS 9 *Financial Instruments* (ie equity instruments measured at fair value through OCI).

IAS 32 as part of the *Annual Improvements to IFRSs 2009-2011 Cycle*. This amendment clarified that an entity applies IAS 12 in accounting for income tax relating to distributions on, and transactions costs of, financial instruments classified as equity. Paragraph BC33C of IAS 32 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.

Do the presentation requirements in paragraph 52B apply only in those circumstances described in paragraph 52A of IAS 12?

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 *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).

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. However, 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. The requirements in paragraphs 52A and 52B of IAS 12 were introduced in 2000 in response to a question regarding when, and how, an entity accounts for the income tax consequences of dividends. In the submitter's jurisdiction, different tax rates existed for distributed and undistributed profits.

23. We have read the staff paper that the International Accounting Standards Committee (IASC) and the Standing Interpretations Committee (SIC) used for discussion when developing the requirements that are now included in paragraphs 52A and 52B of IAS 12. At that time, the IASC and the SIC considered a number of tax-related issues. In addition to the presentation of the income tax consequences of dividends, they discussed, among other things, which tax rate to use in measuring deferred tax assets and liabilities when there are two different tax rates for distributed and undistributed profits. A different set of circumstances was not established for each of the tax-related issues discussed. Accordingly, it

would appear that the IASC and the SIC considered the issue relating to the presentation of the income tax consequences of dividends within that same context (ie in those circumstances in which different tax rates exist for distributed and undistributed profits).

24. Nonetheless, nothing in the staff paper is explicit that the requirements relating to the presentation of the income tax consequences of dividends in paragraph 52B of IAS 12 were intended to apply only in the circumstances in which different tax rates exist for distributed and undistributed profits.

25. Consequently, it is not entirely clear whether, at the time of development, the presentation requirements in paragraph 52B of IAS 12 were intended to apply beyond the circumstances described in paragraph 52A of IAS 12.

Should the presentation requirements in paragraph 52B apply to the income tax consequences of dividends that arise in circumstances other than those described in paragraph 52A of IAS 12?

26. Despite our observation in paragraph 25 of this paper, we think that the applicability of paragraph 52B of IAS 12 should not be limited to only those circumstances described in paragraph 52A of IAS 12. This is because:

    (a) paragraph 52B of IAS 12 requires an entity to link the income tax consequences of dividends to the transactions or events that generated distributable profit, 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 as a result of the distribution of profits.

(c) in general, we think that linking the presentation of income tax consequences to the particular way in which they arise (ie different tax rates rather than different deductibility) leads 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.

27. It is also worthwhile noting the following, which indicates that paragraph 52B of IAS 12 is intended to be applied to the income tax consequences of dividends beyond the circumstances described in paragraph 52A of IAS 12:

(a) Paragraph BC33C of IAS 32, set out in paragraph 17 of this paper, does not limit the Board’s observation regarding the application of paragraph 52B of IAS 12 to only those circumstances described in paragraph 52A of IAS 12.

(b) In February 2003, the IFRIC considered, among other things, a request to clarify an issue similar to the issue considered in this paper (ie whether an entity should present income tax relating to tax deductible payments on financial instruments classified as equity directly in equity or in profit or loss). The IFRIC made the following observation:

> The IFRIC agreed that the underlying issue was how to account for the tax consequences of distributions to external shareholders. The IFRIC observed that the accounting for tax-deductible dividends is explicit in IAS 12. Paragraph 52B of IAS 12 states:
>
> …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 net 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) […][3]

Does paragraph 52B apply to the income tax consequences of the payments described in the submission?

28. As noted above, 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.

29. 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. The determination could depend, for example, on the regulations or laws in the jurisdiction within which the entity operates.

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

Summary and staff recommendation

31. A summary of our analysis is that:

    (a) In our view, the presentation requirements in paragraph 52B of IAS 12, relating to the income tax consequences of dividends, are consistent with

[3] This is an excerpt from *IFRIC – Items not taken onto the agenda (Last Revision: 17 December 2004)*.

the requirements in paragraph 57, 58 and 61A of IAS 12. This is because the presentation requirements in paragraph 52B of IAS 12 specify that:

(i) if dividends give rise to income tax consequences, an entity assesses the underlying transactions and events that generated distributable profits, and not the act of distributing profits itself. In other words, an entity links the income tax consequences of dividends to the transactions or events that generated distributable profits.

(ii) An entity applies the presentation requirements in paragraph 58 of IAS 12 considering the transactions or events that the entity identifies in step (i) above, and not considering the distribution itself.

(b) On the basis of the existing requirements in IAS 12, it is not entirely clear that the presentation requirements in paragraph 52B of IAS 12 would apply to the income tax consequences of dividends that arise in circumstances other than those described in paragraph 52A of IAS 12 (ie other than when there are different tax rates for distributed and undistributed profits).

(c) We think that the applicability of paragraph 52B of IAS 12 should not be limited to the income tax consequences of dividends that arise only in the circumstances described in paragraph 52A of IAS 12. This is because:

(i) paragraph 52B of IAS 12 requires an entity to link the income tax consequences of dividends to the transactions or events that generated distributable profit, and then apply the requirements in paragraph 58 of IAS 12 in determining how to present those income tax consequences; and

(ii) how income tax consequences arise from dividends is not relevant, as long as the income tax consequences arise as a result of the distribution of profits. In other words, what matters is the resulting tax effect, not the mechanism.

(d) In assessing whether the requirements in paragraph 52B apply, an entity determines whether payments on financial instruments classified as equity are distributions of profit. That determination may require judgement.

32. On the basis of the analysis and the assessment of the agenda criteria included in Appendix A of this paper, we recommend that the Interpretations Committee recommend to the Board that it should propose an amendment to IAS 12 to clarify the applicability of the requirements in paragraph 52B of IAS 12 as part of the *Annual Improvements to IFRSs 2015-2017 Cycle.* That amendment would clarify that:

(a) paragraph 52B is applicable to the income tax consequences of dividends in all circumstances; and

(b) 'dividends' in paragraph 52B refers to distributions of profits to holders of equity instruments. Accordingly, in assessing whether to apply paragraph 52B to, for example, payments on financial instruments classified as equity, an entity would determine whether those payments are distributions of profit.

Questions for the Interpretations Committee

1. Does the Interpretations Committee agree with the staff analysis as summarised in paragraph 31 of this paper?

2. Does the Interpretations Committee agree with the staff recommendation as described in paragraph 32 of this paper?

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 feedback received from outreach activities, the issue is common in a number of jurisdictions. Because the issue relates to the income tax consequences of dividends that are treated as a tax deductible item, 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 consequences arise from dividends.
that can be resolved efficiently within the confines of existing Standards and the *Conceptual Framework for Financial Reporting*.	**Yes.** We think that an amendment can resolve the issue efficiently within the confines of existing IFRS Standards because the clarification relates only to the presentation of income tax consequences arising from dividends.
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 IFRS Standards because the clarification relates only to the presentation of income tax consequences 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 scope of income tax consequences to 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 scope of income tax consequences to 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.