International Accounting Standard IAS 12

Income Taxes

January 2012

(incorporating amendments from IFRSs issued up to 31 December 2011, including those with an effective date after 1 January 2012)

BASIS FOR CONCLUSIONS

Basis for Conclusions on IAS 12 *Income Taxes*

This Basis for Conclusions accompanies, but is not part of, IAS 12.

Introduction

BC1 When IAS 12 *Income Taxes* was issued by the International Accounting Standards Committee in 1996 to replace the previous IAS 12 *Accounting for Taxes on Income* (issued in July 1979), the Standard was not accompanied by a Basis for Conclusions. This Basis for Conclusions is not comprehensive. It summarises only the International Accounting Standards Board's considerations in making the amendments to IAS 12 contained in *Deferred Tax: Recovery of Underlying Assets* issued in December 2010. Individual Board members gave greater weight to some factors than to others.

BC2 The Board amended IAS 12 to address an issue that arises when entities apply the measurement principle in IAS 12 to temporary differences relating to investment properties that are measured using the fair value model in IAS 40 *Investment Property*.

BC3 In March 2009 the Board published an exposure draft, *Income Tax* (the 2009 exposure draft), proposing a new IFRS to replace IAS 12. In the 2009 exposure draft, the Board addressed this issue as part of a broad proposal relating to the determination of tax basis. In October 2009 the Board decided not to proceed with the proposals in the 2009 exposure draft and announced that, together with the US Financial Accounting Standards Board, it aimed to conduct a fundamental review of the accounting for income tax in the future. In the meantime, the Board would address specific significant current practice issues.

BC4 In September 2010 the Board published proposals for addressing one of those practice issues in an exposure draft *Deferred Tax: Recovery of Underlying Assets* with a 60-day comment period. Although that is shorter than the Board's normal 120-day comment period, the Board concluded that this was justified because the amendments were straightforward and the exposure draft was short. In addition, the amendments were addressing a problem that existed in practice and needed to be solved as soon as possible. The Board considered the comments it received on the exposure draft and in December 2010 issued the amendments to IAS 12. The Board intends to address other practice issues arising from IAS 12 in due course, when other priorities on its agenda permit this.

Recovery of revalued non-depreciable assets

BC5 In December 2010, the Board incorporated in paragraph 51B of IAS 12 the consensus previously contained in SIC Interpretation 21 *Income Taxes—Recovery of Revalued Non-Depreciable Assets*. However, because paragraph 51C addresses investment property carried at fair value, the Board excluded such assets from the scope of paragraph 51B. Paragraphs BC6 and BC7 set out the basis that the Standing Interpretations Committee (SIC) gave for the conclusions it reached in developing the consensus expressed in SIC-21.

BC6 The SIC noted that the *Framework for the Preparation and Presentation of Financial Statements*[1] stated that an entity recognises an asset if it is probable that the future economic benefits associated with the asset will flow to the entity. Generally, those future economic benefits will be derived (and therefore the carrying amount of an asset will be recovered) through sale, through use, or through use and subsequent sale. Recognition of depreciation implies that the carrying amount of a depreciable asset is expected to be recovered through use to the extent of its depreciable amount, and through sale at its residual value. Consistently with this, the carrying amount of a non-depreciable asset, such as land having an unlimited life, will be recovered only through sale. In other words, because the asset is not depreciated, no part of its carrying amount is expected to be recovered (ie consumed) through use. Deferred taxes associated with the non-depreciable asset reflect the tax consequences of selling the asset.

BC7 The SIC noted that the expected manner of recovery is not predicated on the basis of measuring the carrying amount of the asset. For example, if the carrying amount of a non-depreciable asset is measured at its value in use, the basis of measurement does not imply that the carrying amount of the asset is expected to be recovered through use, but through its residual value upon ultimate disposal.

Recovery of investment properties

Reason for the exception

BC8 IAS 12 applies the principle that the measurement of deferred tax liabilities and deferred tax assets should reflect the tax consequences that would follow from the manner in which the entity expects to recover or settle the carrying amount of its assets and liabilities. In many cases, however, an entity expects to rent out investment property to earn rental income and then sell it to gain from capital appreciation at some point in the future. Without specific plans for disposal of the investment property, it is difficult and subjective to estimate how much of the carrying amount of the investment property will be recovered through cash flows from rental income and how much of it will be recovered through cash flows from selling the asset.

BC9 It is particularly difficult and subjective to determine the entity's expected manner of recovery for investment property that is measured using the fair value model in IAS 40. In contrast, for investment property that is measured using the cost model in IAS 40, the Board believes that the estimates required for depreciation establish the expected manner of recovery because there is a general presumption that an asset's carrying amount is recovered through use to the extent of the amount subject to depreciation and through sale to the extent of the residual value.

1 IASC's *Framework for the Preparation and Presentation of Financial Statements* was adopted by the IASB in 2001. In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.

BC10 To address this issue, the Board introduced an exception to the principle in IAS 12 that applies when an entity adopts an accounting policy of remeasuring investment property at fair value. The purpose of the exception is to reflect the entity's expectation of recovery of the investment property in a practical manner that involves little subjectivity.

BC11 Many respondents to the exposure draft of September 2010 commented that the Board should develop application guidance rather than creating an exception. The Board could have achieved a similar result in some cases by providing application guidance on how to apply the underlying principle to investment property. However, the Board chose an exception because it is simple, straightforward and can avoid unintended consequences by a strict definition of its scope. In fact, this exception is very similar to application guidance. However, it is technically an exception because, in some cases, the asset's carrying amount is assumed to be recovered entirely through sale even though an entity expects it to be recovered partly through sale and partly through use.

BC12 The Board also noted that application guidance would not resolve a practice issue that arises when the future income generated from an asset is expected to exceed the carrying amount of that asset and that future income will be subject to two or more different tax regimes. In those situations, IAS 12 provides no basis for determining which tax rate and tax base apply to the recovery of the carrying amount. The Board concluded that the practical way to resolve this issue was to create an exception that determines the manner of recovery of an asset within the scope of that exception.

Scope of the exception

BC13 The Board understands that the concerns raised in practice relate primarily to investment property measured using the fair value model in IAS 40. The Board proposed in the exposure draft that the exception should also apply to property, plant and equipment or intangible assets measured using the revaluation model in IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets*. That was because in assessing the difficulty and subjectivity involved in determining the expected manner of recovering the carrying amount of the underlying asset, there is no underlying difference between regularly fair valuing assets through a revaluation accounting policy and applying a fair value measurement model.

BC14 Many respondents disagreed with the proposal to include property, plant and equipment or intangible assets measured using the revaluation model in IAS 16 or IAS 38 in the scope of the exception. They stated that many items of property, plant and equipment are recovered through use rather than through sale, and that this is consistent with the definition of property, plant and equipment in IAS 16. In addition, many respondents disagreed with the presumption of recovery through sale when the underlying assets are intangible assets for similar reasons. They also warned of unintended consequences that could arise because of the varying nature of intangible assets. Many respondents suggested limiting the scope of the exception to investment properties measured using the fair value model in IAS 40. Having considered those comments, the Board adopted that suggestion.

BC15 Some respondents supported inclusion of property, plant and equipment in the scope of the exception, including property, plant and equipment measured on a cost basis, because of their concerns about the lack of discounting deferred tax assets and deferred tax liabilities and about a possible double-counting of tax effects (see paragraph BC19). However, the Board concluded that considering concerns about the lack of discounting and about the possible double-counting was outside the limited scope of the amendments.

BC16 The Board made it clear that the exception also applies on initial measurement of investment property acquired in a business combination if the investment property will subsequently be measured using the fair value model in IAS 40. If the exception did not apply in these circumstances, deferred taxes might reflect the tax consequences of use at the acquisition date, but at a later date reflect the tax consequences of sale. The Board believes that measurement of deferred taxes at the acquisition date should be consistent with the subsequent measurement of the same deferred taxes. For the same reason, the Board concluded that the exception should not apply to investment property initially measured at fair value in a business combination if the entity subsequently uses the cost model.

BC17 Having considered the responses to the exposure draft, the Board decided not to extend the exception to other underlying assets and liabilities that are measured at fair value, including financial instruments or biological assets. This is because the Board understands that the most significant current practice issues relate to investment property. In addition, the Board wished to avoid unintended consequences of expanding the scope to other assets and liabilities that are measured on a fair value basis.

BC18 The Board concluded that the amendments should apply to all temporary differences that arise relating to underlying assets within the scope of the exception, not just those separate temporary differences created by the remeasurement of the underlying asset. This is because the unit of account applied in determining the manner of recovery in the Standard is the underlying asset as a whole, not the individual temporary differences.

Measurement basis

BC19 The Board decided that when the exception applies, there should be a presumption that deferred taxes should be measured to reflect the tax consequences of recovering the carrying amount of the investment property entirely through sale. In making that decision, the Board considered various views expressed by interested parties, which included, but were not limited to the following:

(a) the tax effect would be double-counted in some situations if deferred taxes are measured on the basis of the tax consequences of use, because the investment property is measured at fair value, which reflects some of these tax consequences; and

(b) presuming sale is consistent with a fair value measurement basis that reflects the price that would be received if the investment property is sold.

BC20 Many respondents to the exposure draft said that choosing a measurement basis of fair value is an accounting policy choice that does not imply or predict recovery of the investment property through sale. Many also said that the proposed exception would solve the double-counting problem partially but not completely. The Board noted that the aim of the exception was neither to link the accounting policy with measurement of deferred taxes (see paragraph BC7), nor to remove completely the double-counting of tax effects (see paragraph BC15). The aim of this exception is to provide a practical approach when determination of the expected manner of recovery is difficult and subjective.

BC21 In many cases when an entity chooses the fair value model for investment property, investment properties are recovered through sale. Even if an investment property earns income through rental use in a given period, the value of the future earnings capacity of the investment property will often not decrease and that value will ultimately be realised through sale. Therefore, the Board retained its proposal to introduce a presumption of recovery through sale.

BC22 The Board made that presumption rebuttable because the Board believes that it is not always appropriate to assume the recovery of investment property through sale. The Board initially proposed in the exposure draft that the presumption of recovery through sale is not appropriate when the entity has clear evidence that it will consume the asset's economic benefits throughout its economic life. The Board set a criterion that refers to consumption of the asset's economic benefits, rather than to the recovery of the carrying amount, because the Board understands that there is diverse practice regarding the meaning of the recovery of the carrying amount through use or through sale.

BC23 After considering the responses to the exposure draft, the Board reworded the rebuttable presumption so that clear evidence would not be required to rebut it. Instead, the presumption is rebutted if an asset is held within a business model whose objective is to consume substantially all of the economic benefits embodied in the investment property over time, rather than through sale. Many respondents were concerned that, because clear evidence is an ambiguous term, the requirement to gather clear evidence would have been onerous for entities that have no problem applying the existing principle in IAS 12, and could have led to abuse by entities that choose whether to gather clear evidence to achieve a favourable result. The Board chose to use the term 'business model' because it is already used in IFRS 9 *Financial Instruments* and would not depend on management's intentions for an individual asset. Many respondents were concerned that the presumption would lead to inappropriate results in some cases because it would not be rebutted if a minor scrap value would be recovered through sale. The Board also reworded the rebuttable presumption in order to respond to those concerns. The Board also made it clear that the presumption of recovery through sale cannot be rebutted if the asset is non-depreciable because that fact implies that no part of the carrying amount of the asset would be consumed through use (see paragraph BC6).

BC24 The Board also considered other approaches to the measurement of deferred tax liabilities and deferred tax assets when the exception applies, specifically whether deferred taxes should be measured on the basis of the lower of the tax consequences of recovery through use and through sale. However, the Board rejected such an approach, noting that it would have created:

(a) conceptual and practical concerns about whether deferred tax assets should be measured to reflect the lower of, or higher of, the tax consequences of use and of sale;

(b) a measurement basis that some believe would be arbitrary; and

(c) concerns that entities might be required to measure deferred taxes on a basis that is inconsistent with their expectations of recovery of the carrying amount of the underlying asset.

BC25 Some respondents to the exposure draft drew the mistaken conclusion that the exposure draft required presumption of *immediate* sale at the end of the reporting period when assessing the presumption of recovery through sale. The Board observed that paragraph 47 of IAS 12 requires deferred tax assets and liabilities to be measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled on the basis of tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period. This requirement applies even when the presumption of recovery through sale is used. For clarification, the Board adjusted the illustrative example following paragraph 51C to reflect the requirement in paragraph 47.

BC26 In the exposure draft, the Board proposed to withdraw SIC-21. However, many respondents commented that SIC-21 should be retained in order to avoid unintended consequences. Having considered the responses to the exposure draft, the Board decided to incorporate SIC-21 into IAS 12 in its entirety after excluding from the scope of SIC-21 the investment property subject to the requirement in paragraph 51C.

Assessment of deferred tax assets

BC27 The Board inserted paragraph 51E to confirm that the requirements in paragraphs 24–33 (deductible temporary differences) and paragraphs 34–36 (unused tax losses and unused tax credits) relating to assessment of deferred tax assets continue to apply even when the presumption of recovery through sale arises. The Board did not think that additional guidance would be necessary.

Disclosure requirement

BC28 The Board proposed in the exposure draft disclosure of the fact of, and reasons for, the rebuttal of the presumption of recovery through sale if the entity has rebutted the presumption. However, many respondents said that this disclosure would add little or no value to the financial statements. IAS 1 *Presentation of Financial Statements* already requires disclosures regarding material judgements. Thus, there is no need to disclose a particular judgement on specific types of assets. The Board was convinced by those arguments and did not proceed with the proposed disclosure requirement.

The costs and benefits of the amendments to IAS 12

BC29 Computation of the tax consequences of selling assets is complex in some tax jurisdictions and there are concerns that the amendments to IAS 12 will increase the administrative burden for some entities in those tax jurisdictions.

BC30 However, the Board believes that the benefit of providing the exception outweighs this potential increase in administrative burden for some entities. This is because the purpose of the exception is to enable preparers to measure deferred taxes in these circumstances in the least subjective manner and in so doing enhance the comparability of financial information about deferred taxes for the benefit of users of financial statements. It is also expected to result in an overall reduction of the administrative burden for entities that have previously had to consider the tax consequence of both use and sale of an investment property when measuring deferred taxes.

BC31 Many respondents to the exposure draft said that entities would not benefit from the amendments in jurisdictions in which this practice issue did not exist but would suffer from an increased administrative burden as a result of the amendments. Their criticism mainly focused on the rebuttable presumption, as discussed in paragraphs BC22 and BC23. They also said that the disclosure requirement proposed in the exposure draft would be onerous.

BC32 After considering the responses to the exposure draft, the Board narrowed the scope of the exception to apply only to investment property carried at fair value. It reworded the rebuttable presumption so that clear evidence would no longer be required to rebut the presumption. The Board also did not pursue the proposed disclosure requirement regarding the fact of, and reason for, the rebuttal. After those changes, the Board believes that the amendments will not be onerous for entities that have previously been able to establish without difficulty how they expect to recover investment property carried at fair value.

Transition and effective date

BC33 IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires an entity to apply retrospectively a change in accounting policy resulting from the initial application of an IFRS that does not have a transition provision. The Board did not include any transition provision in the amendments because, in the Board's view, it would not be unduly burdensome for entities to apply the changes to IAS 12 retrospectively.

BC34 The Board acknowledges that the amendments may add some administrative burden if they apply to investment property acquired in a business combination that occurred in a previous reporting period. For example, it could be difficult to restate goodwill and recalculate previous impairment reassessments if some information is not available and an entity is unable to separate the effects of hindsight. However, the Board reasoned that the amendments apply only to specific circumstances. Moreover, IAS 8 provides sufficient guidance to deal with cases when it might be impracticable to reassess impairment of goodwill or recoverability of deferred tax assets.

BC35 Consequently, the Board concluded that the cost of requiring retrospective application is outweighed by the benefit of consistent application of the amendments by entities to all periods presented in the financial statements. Accordingly, the Board decided that entities should apply the amendments to IAS 12 retrospectively in accordance with IAS 8.

First-time adoption of IFRSs

BC36 The Board identified no reason to adjust the exception for application by a first-time adopter at its date of transition to IFRSs.