Project **Annual Improvements – 2009–2011 cycle**

Topic **IAS 32 *Financial Instruments: Presentation* – Tax effect of distributions to holders of equity instruments**

Purpose of this paper

1. This paper discusses a conflict between IAS 12 *Income Taxes* and IAS 32 *Financial Instruments: Presentation* in respect of the accounting for income tax consequences of distributions to holders of equity instruments.
2. This paper asks the Board to consider as part of the *Annual Improvements Project* (AIP) a clarification that the income tax consequences of distributions to holders of equity instruments, as well as those of transaction costs of an equity transaction, should be accounted for in accordance with IAS 12.
3. This paper:
   (a) provides background information;
   (b) explains the issue;
   (c) analyses the issue raised;
   (d) makes a staff recommendation for a proposed amendment to IFRS; and
   (e) asks the Board whether they agree with the staff recommendation.

Background information

4. During the short-term convergence project on income tax, the staff received a request to resolve a conflict between IAS 12.52A and IAS 12.52B and IAS 32.35 in respect of the accounting for the income tax consequences of

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

distributions to holders of an equity instrument. The conflict exists because both IAS 32 and IAS 12 provide guidance on income tax on equity transactions but the guidance they give is different.

5. The Board proposed a consequential amendment to IAS 32 to resolve the issue in the Exposure Draft *Income Tax* (ED) issued in March 2009. However, in October 2009, the Board indicated that it would conduct a limited scope project to amend IAS 12 rather than finalising the ED.

6. The proposal included in the ED to resolve this issue will not be part of that limited scope project. This is because the staff think that the most efficient way to resolve this matter is to amend IAS 32 as part of the AIP.

7. In the IFRS Interpretations Committee meeting in March 2010, the Interpretations Committee agreed with the staff proposal to recommend that the Board should add this issue to the 2009–2011 AIP cycle[1].

The issue

8. IAS 12 states:

> 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*

[1] The Interpretations Committee recommended the Board should amend IAS 32 to clarify that the income tax effect of both distributions to equity holders and transaction costs relating to equity transactions should be accounted for in accordance with IAS 12. (IFRIC Update March 2010)

> *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) (emphasis added)

9. On the other hand, IAS 32.35 states:

> 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 debited by the entity directly to equity, net of any related income tax benefit.* Transaction costs of an equity transaction shall be accounted for as a deduction from equity, net of any related income tax benefit. (emphasis added)

10. While IAS 12, subject to certain exceptions, requires recognition of income tax consequence of dividends in profit or loss, IAS 32 requires debiting the distribution directly to equity, net of any related income tax benefits. This creates a potential conflict between the two standards.

11. The following is an example of circumstances which would create a conflict between IAS 12 and IAS 32.

An entity has earnings of CU100 in Year 1. In Year 3, the entity paid a dividend of CU100 that relates to the earnings in Year 1, rather than relating to a return of capital. In the entity's tax jurisdiction, the tax rate applicable to undistributed earnings is 40%. However the tax rate applicable to distributed earnings is 30%.

In accordance with IAS 12, in Year 1 the entity recognises a current tax liability of CU40 (CU100 x 40%) and corresponding tax expense in profit or loss. In Year 3, the entity recognises current tax receivable of CU10 (CU100 x (40%-30%)) and corresponding tax income in profit or loss. The tax income in Year 3 is recognised in profit or loss, because according to paragraph 52B of IAS 12 the tax effect of dividends is more directly linked to past transactions or events than to distributions to owners.

In contrast, in accordance with IAS 32.35, distributions to holders of equity instruments shall be debited directly to equity, net of any related income tax benefits. The Year 1 entry would be in accordance with IAS 12, with

recognition of a current tax liability of CU40 (CU100 x 40%) and corresponding tax expense in profit or loss, consistent with the above analysis. However in Year 3, the dividend is considered as an equity transaction. As a result the entity recognises current tax receivable of CU10 (CU100 x (40%-30%)) but, in accordance with IAS 32.35, the corresponding tax income is recognised in equity, not profit and loss.

Staff Analysis

Paragraph 52A and 52B of IAS 12

12. IAS 12.52A and IAS 12.52B were introduced in 2000 and took effect from 1 January 2001 in response to a question raised regarding when, and how, income tax consequences of dividends to shareholders of an entity should be accounted for. In the requesters' jurisdiction, undistributed profits were subject to a corporate tax rate of 45%, but distributed income was taxed at 30%.
13. Entities that paid dividends from previously undistributed income could receive a tax credit (or tax refund) equal to the difference between the income tax computed at the undistributed rate and the income tax computed at the distributed rate. Before the revision in 2000, IAS 12 was silent on the accounting for the income tax consequences of dividends.
14. At that time, the IASC concluded that it would not be appropriate to account for the income tax consequences of the dividend as a deferred tax asset until the transaction that triggers the income tax refund (ie the payment of the dividend) is recognised as a liability. Consequently, IAS 12 was amended to require an entity to measure tax assets and liabilities using the undistributed tax rate.
15. The revised standard also requires an entity to recognise the income tax effect of dividends in profit or loss in accordance with the requirements in IAS 12.58 except in situations stated in IAS 12.58(a) and (b).

16. According to paragraph 52B, the income tax consequences of dividends are more directly linked to the past transactions or events that generated the retained earnings to be distributed than to the act of distribution to owners. Paragraph 58 states:

    > 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 to 65); or
    >
    > (b) a business combination (see paragraphs 66 to 68).

Consistency with paragraph 58 of IAS 12

17. In the Interpretations Committee meeting in March 2010, a question was raised by one of the Interpretations Committee members as to whether IAS 12.58 is inconsistent with the requirements in IAS 12.52B. The staff believe that the guidance within IAS 12 on accounting for the income tax effects of dividends is consistent.

18. The principle in IAS 12.58 is that current and deferred tax shall be recognised in profit and loss subject to two exceptions included in IAS 12.58(a) and IAS 12.58(b). The exception included in IAS 12.58(a) applies to transactions that are recognised outside of profit and loss, such as those recognised directly in equity. This implies that because dividend transactions are recognised directly in equity, the tax on dividends should not be recognised in profit and loss, but should instead be recognised in equity in accordance with IAS 12.58(a).

19. However, paragraphs 52A and 52B of IAS 12 provide specific guidance on the accounting for the income tax consequences of dividends. This guidance requires an entity to link the dividends to the transaction or event that generated the distributed earnings. To the extent that the dividend is linked to past

transactions recognised in profit and loss, the income tax on the dividend should be recognised in profit and loss.

20. However, only if the dividend relates to past transactions recognised outside of profit and loss should the entity apply the exception in IAS 12.58(a), and recognise the income tax effects of the dividend outside of profit and loss.

Paragraph 35 of IAS 32

21. The requirements in paragraph 35 were originally provided in SIC-17 *Equity - Costs of an Equity Transaction*, which was incorporated into IAS 32 in 2003. SIC-17 referred to IAS 12.61 (later, paragraph 61 was replaced with paragraph 61A), which stated that current and deferred tax should be charged or credited directly to equity if the tax related to items that were credited or charged, in the same or different period, directly to equity.

22. The staff understand that the intention of IAS 32.35 was to follow the requirements under IAS 12 in accounting for the income tax consequences of costs of an equity transaction. SIC-17 took effect on 1 January, 1999 before paragraphs 52A and 52B were added to IAS 12 in January 2001. SIC-17 adopted the same view as IAS 12.61, on the grounds that a separate tax asset or liability arose when dividends were paid.

23. However, as noted above, IAS 12 now specifically addresses this issue in paragraphs 52A and 52B, with paragraph 61A only applying in certain circumstances.

Staff recommendation

Annual Improvements criteria assessment

24. The staff believe that the most efficient way to resolve this issue is to amend IAS 32 through the AIP. We believe that the issue meets the annual

improvements criteria because it is a necessary amendment to IFRSs, and the AIP is the fastest way to address the issue.

25. The staff also believe that the best way to amend IAS 32 is for IAS 32 to require accounting for income tax in accordance with IAS 12, instead of addressing the specific accounting treatment for income tax on equity transactions within IAS 32 itself.

26. From this standpoint, the staff also recommend that sentences in paragraphs 35, 37 and 39 of IAS 32 that address income tax accounting for transaction costs should also be amended. This would also require income tax relating to transaction costs of an equity transaction to be accounted for in accordance with IAS 12.

27. The proposed amendment wording is included Appendix A.

Effective date and transition

28. The staff propose that an entity shall apply the amendment retrospectively for annual periods beginning on or after 1 January 2012. Earlier application shall be permitted. If an entity applies the amendment for an earlier period it shall disclose that fact.

29. The staff do not think that any transitional relief is necessary, because the proposed amendment is a clarification to confirm the current practice according to IAS 12.

30. In addition, the proposed amendment could affect profit or loss in the comparative periods but this would not change any component of equity. Consequently, the staff do not think that hindsight will be used to apply the change retrospectively.

Consequential amendments

31. Paragraph 11 of IFRIC 2 *Member's Shares in Co-operative Entities and Similar Instruments* should also be amended because it refers to paragraph 35 of IAS 32

and contains the similar phrase *('distributions to holders of an equity instrument are recognised directly in equity, net of any related income tax benefit')*.

Questions to the Board

32. The Interpretations Committee discussed this issue and agreed to recommend that the Board should add this issue to the annual improvement process. The questions to the Board are:

Question 1: Adding to the Annual Improvement Project
Does the Board agree with the staff recommendation to add the issue to *Annual Improvements*?

Question 2: Proposed amendment to IAS 32
Does the Board agree with the proposed amendment to IAS 32 in Appendix A to clarify that income taxes relating to equity transactions are to be accounted for in accordance with IAS 12?

Question 3: Proposed effective date and transition
Does the Board agree with the proposed effective date and transition?

Appendix A - Proposed amendment to IAS 32 *Financial Instruments: Presentation*

Paragraphs 35, 37 and 39 are amended (new text is underlined and deleted text is struck through). Paragraph 35A is added.

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 debited by the entity directly to equity~~, net of any related income tax benefit~~. Transaction costs of an equity transaction shall be accounted for as a deduction from equity~~, net of any related income tax benefit~~.

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

37 An entity typically incurs various costs in issuing or acquiring its own equity instruments. These costs might include registration and other regulatory fees, amounts paid to legal, accounting and other professional advisers, printing costs and stamp duties. The transaction costs of an equity transaction are accounted for as a deduction from equity ~~(net of any related income tax benefit)~~ to the extent that they are incremental costs directly attributable to the equity transaction that would otherwise have been avoided. The costs of an equity transaction that is abandoned are recognised as an expense.

39 The amount of transaction costs accounted for as a deduction from equity in the period is disclosed separately ~~under~~ in accordance with IAS 1. ~~The related amount of income taxes recognised directly in equity is included in the aggregate amount of current and deferred income tax credited or charged to equity that is disclosed under IAS 12 *Income Taxes*.~~

Appendix B - Consequential amendment to IFRIC 2 *Member's Shares in Co-operative Entities and Similar Instruments*

Paragraph 11 of IFRIC 2 is amended (the amended paragraph is shown with the new text underlined and deleted text struck through).

11 As required by paragraph 35 of IAS 32, distributions to holders of equity instruments are recognised directly in equity~~, net of any income tax benefits~~. Interest, dividends and other returns relating to financial instruments classified as financial liabilities are expenses, regardless of whether those amounts paid are legally characterised as dividends, interest or otherwise.

Appendix C - Basis for Conclusions on proposed amendment to IAS 32 *Financial Instruments: Presentation*

The Basis for Conclusions accompanies, but is not part of, the proposed amendments.

Income tax consequences of distributions to holders of an equity instrument and of transaction costs of an equity transaction

BC1 The Board was asked to rectify an inconsistency between IAS 12 *Income Taxes* and IAS 32 *Financial Instruments: Presentation* regarding the recognition of income tax relating to distributions to holders of an equity instrument. Paragraph 52B of IAS 12 requires the recognition of the income tax consequences of dividends in profit or loss except when the circumstances described in paragraph 58(a) and 58(b) of IAS 12 arise. However, paragraph 35 of IAS 32 requires the recognition of income tax relating to distributions to holders of an equity instrument in equity.

BC2 The Board noted that the intention of IAS 32 was to follow the requirements in IAS 12 for accounting for income tax relating to distributions to holders of an equity instrument and transactions costs of an equity transaction. Consequently, the Board added paragraph 35A to IAS 32 to clarify this intent.