Project: **Income Tax**

Topic: **Deferred tax on remeasurement of property at fair value**

Purpose of this paper

1. In the March Board meeting, the Board directed the staff to explore the possibility of an exception for investment properties measured using the fair value model under IAS 40 *Investment Property*, based on the tax consequences of lower of sale or use.

2. The staff considered the possibility of an exception in line with the Board direction and noted two alternatives to achieve a similar result. The alternatives are:

   (a) An exception to the measurement principles based on the expected manner of recovery under IAS 12.52 (Alternative 1), or

   (b) Extending the guidance in IAS 12.52 on the expected manner of recovery (Alternative 2).

3. Alternative 1 focuses on the entity's purpose in holding the investment properties when it chooses to use the fair value model under IAS 40. It would requires measurement of the deferred tax liability for them at the lower tax consequence of sale or use.

4. Alternative 2 focuses on the entity's expectation as to whether the carrying amount of the properties is reduced during the period of use. If the entity expects no reduction of the carrying amount during the period of use, the proposed guidance would clarify that entity expects to recover the carrying amount by sale.

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.

5. Alternative 1 (an exception) would apply only to investment properties for which the entity uses the fair value model under IAS 40. In contrast, alternative 2 (extended guidance) may possibly apply not only to investment properties using the fair value model under IAS 40 but also property, plant and equipment and intangibles assets for which an entity uses the revaluation model under IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*.

6. When investment properties (and also property, plant and equipment and intangible asset, if we take alternative 2) are measured at fair value upon a business combination, the similar temporary differences may arise. The staff think that the same exception (or the extended guidance under alternative 2) should also apply to temporary differences arising from measurement of investment properties (and property plant and equipment and intangible asset if we take alternative 2) at fair value upon a business combination because they have the same difficulty and subjectivity in determination of the expected manner of recovery.

7. This paper contains:

   (a) explanation of the issue,

   (b) explanation of Alternative 1,

   (c) explanation of Alternative 2,

   (d) staff recommendation, and

   (e) question to the Board.

Explanation of the issue

8. When an entity measures an investment property at fair value using the fair value model in IAS 40, this creates a temporary difference, unless the remeasurement at fair value also results in an equal adjustment to the tax base of the asset at the same time (a similar temporary difference arises from revaluation of an asset under other IFRSs).

9. Under IAS 12 *Income Taxes*, the entity must first determine how it expects to recover the carrying amount of the property. That expectation determines the tax base of the asset and the applicable tax rate.

10. For example, when the entity expects to recover the carrying amount of investment property by sale, the tax base of the investment property is the amount of tax deduction available against the sale proceeds and the applicable tax rate is the tax rate that applies to the sale of the investment property.

11. When the entity expects to recover the carrying amount of investment property by use, the tax base of the investment property is the aggregate amount of tax deductions available against future rental income. That amount is generally the depreciable amount of the investment property for tax purposes. The applicable tax rates are the tax rates that apply to the future rental income.

12. Entities choose the fair value model for investment property generally when they hold investment property for capital appreciation or when they hold it to earn rental income for a while, with the aim of gaining from capital appreciation at some time in the future.

13. In applying the expectation approach under IAS 12 to a situation when entities hold the investment property to earn rental income with the aim of gaining from capital appreciation at some time in the future, a question arises as to whether the entity's expectation on recovery of the carrying amount of the investment property should be sale, use or combination of both and how that expectation should affect the calculation of deferred tax.

14. SIC 21 *Recovery of Revalued Non-Depreciable Asset* provides guidance on determining the expected manner of recovery when properties are revalued at fair value but SIC 21 deals only with non-depreciable assets such as land. There is no other guidance in the context of IAS 12 to determine the expected manner of recovery for depreciable properties.

15. The lack of guidance creates various problems in practice. Particularly when an entity remeasures the investment property at fair value, expects to use it to earn rental income for a while, with the aim of gaining from capital appreciation at

some time in the future, some think that calculating deferred tax liability based solely on recovery by use does not create the right answer because it ignores the expectation of selling the property in the future. On the other hand, it may be subjective to estimate how much of the carrying amount would be recovered by cash inflows from rental if the entity does not have specific plans for disposal at a particular time.

16. Some also argue that the tax consequence of future rental income is in some circumstances double-counted if a deferred tax liability is recognised based on recovery by use because fair value already reflects the tax that will arise on future rental income.

Alternative 1 – an exception to the measurement principle in IAS 12.52

17. If the Board introduces an exception for investment properties remeasured to fair value, that will be an exception to the measurement principle in IAS 12.52. That principle is based on the expected manner of recovery.

18. IAS 12.52 states:

> In some jurisdictions, the manner in which an entity recovers (settles) the carrying amount of an asset (liability) may affect either or both of:
>
> (a) the tax rate applicable when the entity recovers (settles) the carrying amount of the asset (liability); and
>
> (b) the tax base of the asset (liability).
>
> In such cases, an entity measures deferred tax liabilities and deferred tax assets using the tax rate and the tax base that are consistent with **the expected manner of recovery or settlement**. [emphasis added]

19. Under alternative 1, the Board would exclude from the scope of IAS12.52 investment properties that are remeasured at fair value and instead require an entity to measure the deferred tax at the lower tax consequences of sale or use (ie the lower of two amounts: the tax consequences of the recovery of the carrying amount by sale and the tax consequences of recovery by use) when an

entity expects to use the investment properties with the aim of gaining from capital appreciation at some time in the future.

20. One argument for creating another exception and providing a specific requirement on measurement of the deferred tax liability in that particular situation is that, without a specific requirement, determining the expected manner of recovery would be very subjective.

21. A similar temporary difference also arise from not just (a) below but (b) and/or (c):

    (a) investment properties measured using the fair value model under IAS 40;

    (b) property, plant and equipment that are measured at fair value using the revaluation model under IAS 16 *Property, Plant and Equipment* and intangible assets measured at fair value using the revaluation model under IAS 38 *Intangible Assets*;

    (c) financial instruments measured at fair value under IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments*.

22. However, the staff think that the exception should be limited to (a) investment properties using the fair value model under IAS 40.33-55 because;

    (a) the purpose of holding investment properties could include both sale and use in accordance with IAS 40.5, which defines investment properties as properties held to earn rentals or for capital appreciation or both;

    (b) the sale of assets is not anticipated in the definition of property, plant and equipment in accordance with according IAS 16.6, which defines properties, plants and equipment as tangible assets that are held for use in production or supply of goods or services, for rental to others, or for administrative purposes;

(c) property plant and equipment under IAS 16 (other than land) and intangible assets with finite life under IAS 38 are subject to regular depreciation. As the basis of conclusions on SIC 21 explains, this implies that the entity expects to recover the carrying amount through use to the extent of its depreciable amount; and

(d) financial instruments are also subject to remeasurement at fair value but the staff have not heard of any problems in practice regarding the tax effect of subsequent measurement of financial instruments at fair value.

23. The similar temporary differences also arise from measurement of investment properties at fair value upon a business combination. The staff think that the same exception should also apply to those temporary differences arising upon a business combination because they have the same difficulty in determination of the expected manner of recovery. However, for the same reason as stated above, the exception should not be extended to assets other than investment properties.

24. An advantage of the exception (alternative 1) over the extended guidance (alternative 2) is that there is less risk of the exception in alternative 1 being applied to analogous cases than of the guidance under alternative 2 being applied to analogous cases.

25. The risk of the exception is that it may be seen as a rule based rather than principle based.

Alternative 2 – extended guidance on the expected manner of recovery in IAS 12.52

26. The staff think that a similar result can be achieved by extending guidance on IAS 12.52 regarding the entity's expected manner of recovery of an asset.

27. The guidance would be an amendment to and/or extension of SIC 21. Currently, SIC 21 is the only guidance on IAS12.52 regarding the entity's expected manner of recovery. It states:

> The deferred tax liability or asset that arises from **the revaluation of a non-depreciable asset** in accordance with IAS 16.31 shall be measured on the basis of the tax consequences that would follow from **recovery of the carrying amount of that asset through sale**, regardless of the basis of measuring the carrying amount of that asset. Accordingly, if the tax law specifies a tax rate applicable to the taxable amount derived from the sale of an asset that differs from the tax rate applicable to the taxable amount derived from using an asset, the former rate is applied in measuring the deferred tax liability or asset related to a non-depreciable asset. [emphasis added]

28. SIC 21 was written based on an understanding that 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. Conversely, if the asset is not depreciated, no part of its carrying amount is expected to be recovered through use[1].

29. SIC 21 also applies to investment properties that are measured at fair value if they would be considered non-depreciable assets if IAS 16 *Property, Plant and Equipment* were to be applied (ie land). SIC 21 does not apply to investment properties other than land.

30. However, in a situation where an entity uses the fair value model for investment property other than land and expects that the market price of that investment property will keep rising, it expects that the carrying amount will never reduce. Similarly to the reason for guidance in SIC 21, it can be said that no part of the carrying amount should be expected to be recovered through use if the carrying amount is not expected to reduce during the use of the property.

31. The guidance needed for alternative 2 could be extended to other property, plant and equipment under IAS 16 (ie not just land) and intangible assets under IAS 38 for which an entity uses the revaluation model. Even though these assets are still subject to regular depreciation after the revaluation, their carrying amount would not reduce if an entity expects that the property value keeps rising faster than the depreciation.

[1] SIC 21 Basis for Conclusions

32. Similarly, it could also apply when an entity measures investment property and also property, plant and equipment and intangibles assets at fair value upon a business combination if the entity expects that the carrying amount would not reduce during the period of use.

33. As a result, in a situation when an entity does not expect a decrease in the value of the property before the entity sells the asset, SIC 21 could be extended for investment properties using the fair value model, and property plant and equipment and intangible assets using the revaluation model, and also when such assets are measured at fair value upon a business combination. The extension would mean that deferred tax for these assets would be measured on the basis of tax consequences that would follow from recovery of the carrying amount of the asset through sale.

34. The advantage of alternative 2 is that it would extend the guidance provided on the measurement principle under IAS 12.52; thus would not create another exception.

35. The risk of giving the guidance is that it could be practically difficulty to determine whether, and in which case, it is reasonable to conclude that an entity expects no decrease in the property value in future. Assuming that the value of property does not decrease may contradict with the fact that the property has a finite economic life.

Staff recommendation

36. The staff recommend alternative 1 because the staff weight the risk of the guidance (practical difficulty of determining whether the value will decline in the future) more than the advantage of avoiding an exception to the principle. Although alternative 1 would require a new exception, the staff recommend it because alternative 1:

    (a) applies more narrowly than alternative 2, and so avoids the risk of unintended consequences; and

(b) requires less subjectivity than alternative 2, because it does not require an entity to predict whether the property value will decline in future.

Questions to the Board

37. The staff would like to put the following questions to the Board:

Question 1 for the Board

1. Does the Board agree with the staff recommendation to adopt Alternative 1, an exception to the principle in IAS 12.52 rather than Alternative 2, guidance on the expected manner of recovery in IAS 12.52?

Question 2 for the Board

2. Does the Board agree that the scope of the exception should be limited to investment properties for which an entity uses the fair value model under IAS 40 and those which are measured at fair value upon a business combination?