Endorsement of Deferred Tax: Recovery of Underlying Assets
(Amendments to IAS 12 Income Taxes)

Introduction, background and conclusions

Attachment 1: Effect study prepared by the European Financial Reporting Advisory Group (EFRAG)

Attachment 2: Endorsement advice prepared by the European Financial Reporting Advisory Group (EFRAG)
1. **Effect Study**

The European Commission has agreed with the European Parliament that effect studies should be prepared for new accounting standards and interpretations up for endorsement in the European Union (EU). The Commission Services together with the European Financial Reporting Advisory Group (EFRAG) prepare these studies containing description of the accounting issues involved, results from stakeholder consultations as well as analysis of effects of using the new accounting rules in the EU.

EFRAG has prepared an effect study for the adoption of Deferred Tax: Recovery of Underlying Assets (Amendments to IAS 12 *Income Taxes*) (attached). As the EFRAG effect study refers to the endorsement advice, we also included it in attachments.

This cover note contains background information, comments and a conclusion by the Commission Services.

2. **Background on Deferred Tax: Recovery of Underlying Assets (Amendments to IAS 12 Income Taxes)**

Deferred Tax: Recovery of Underlying Assets (Amendments to IAS 12) (*the Amendments*)

The objective of IAS 12 is to prescribe the accounting treatment for income taxes. IAS 12 requires an entity to recognise a deferred tax liability or asset (and a corresponding deferred tax expense or income) for the estimated future tax consequences of temporary differences. Under IAS 12, deferred tax liabilities are measured on a basis that reflects the manner in which the entity expects to recover the carrying amount of an asset.

The Amendments are intended to provide relief to entities that find it difficult to determine the manner of recovery (use or sale) of depreciable investment property measured at fair value under IAS 40 *Investment Property*. Therefore the Amendments provide a practical solution and introduce an exception to the measurement principle in IAS 12 in the form of a rebuttable presumption that assumes that the carrying amount of an investment property measured at fair value will be recovered through sale. An entity is required to rebut the presumption if the investment property is depreciable and 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.

The Amendments result from proposals included in the exposure draft Deferred Tax: Recovery of Underlying Assets (proposed amendments to IAS 12) published in September 2010. The Amendments are effective for annual periods beginning on or after 1 January 2012, with earlier application permitted.

**EFRAG consultations**

EFRAG published its initial draft endorsement advice and effect study report in November 2011 and finalised its advice in January 2012. When finalising its advice EFRAG took the comments received in response to its request for comments on its draft endorsement advice into account. EFRAG supports the Amendments and recommends that the Amendments should be adopted for use in Europe.
3. **EFFECT STUDY**

*Main points identified in the EFRAG effect study*

**Relevance, reliability, comparability and understandability**

In EFRAG's view, the information resulting from the application of the Amendments will be relevant when (a) an entity has a clear expectation of recovering the carrying amount of the investment property through sale; and (b) if the investment property 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. In this case, the presumption would be rebutted and the measurement principle in IAS 12 would apply. Only in rare circumstances would an entity produce information that does not reflect the real tax consequences that are expected to arise when the underlying asset is recovered. The Amendments also reduce the subjectivity of measurement by introducing a practical and single measurement approach to calculate deferred tax on investment property measured at fair value under IAS 40. For this reason, the Amendments would also satisfy the reliability and comparability criteria. The Amendments set to provide relief to those entities that find it difficult to determine the manner of recovery of investment property measured at fair value, and do not introduce new requirements or complexities that may impair understandability. Therefore, EFRAG's assessment is that the Amendments also satisfy the understandability criterion.

*Costs and benefits for preparers and users*

EFRAG considers that the users and preparers are likely to benefit from the Amendments to IAS 12 because the Amendments would not significantly affect the costs for preparers and users whilst users are likely to benefit from the Amendments because the information provided is likely to be less subjective and therefore enhance comparability of information.

4. **OVERALL COST-BENEFIT CONSIDERATIONS AND COMMISSION SERVICES CONCLUSIONS**

On the basis of EFRAG's effect study, the Commission Services have considered the main costs and benefits of endorsing the Amendments to IAS 12. The Services conclude that the benefits of the Amendments outweigh the costs incurred.

The Commission Services believe that the Amendments to IAS 12 will have positive cost-benefits effects and that they should therefore be endorsed in the EU without delay.
The costs and benefits of implementing Deferred Tax: Recovery of Underlying Assets (Amendments to IAS 12)

Introduction

1 Following discussions between the various parties involved in the EU endorsement process, the European Commission decided in 2007 that more extensive information than hitherto needs to be gathered on the costs and benefits of all new or revised Standards and Interpretations as part of the endorsement process. It has further been agreed that EFRAG will gather that information in the case of Deferred Tax: Recovery of Underlying Assets (Amendments to IAS 12) (‘the Amendments’).

2 EFRAG first considered how extensive the work would need to be. For some Standards or Interpretations, it might be necessary to carry out some fairly extensive work in order to understand fully the cost and benefit implications of the Standard or Interpretation being assessed. However, in the case of the Amendments, EFRAG’s view is that the cost and benefit implications can be assessed by carrying out a more modest amount of work. The results of the consultations that EFRAG has carried out seem to confirm this. Therefore, as explained more fully in the main sections of this report, the approach that EFRAG has adopted has been to carry out detailed initial assessments of the likely costs and benefits of implementing the Amendments in the EU, to consult on the results of those initial assessments, and to finalise those assessments in the light of the comments received.

EFRAG’s endorsement advice

3 EFRAG also carries out a technical assessment of all new and revised Standards and Interpretations issued by the IASB against the so-called endorsement criteria and provides the results of those technical assessments to the European Commission in the form of recommendations as to whether or not the Standard or Interpretation assessed should be endorsed for use in the EU. As part of those technical assessments, EFRAG gives consideration to the costs and benefits that would arise from implementing the new or revised Standard or Interpretation in the EU. EFRAG has therefore taken the conclusion at the end of this report into account in finalising its endorsement advice.

A summary of the Amendments

Background

4 IAS 12 requires an entity to recognise a deferred tax liability or asset (and a corresponding deferred tax expense or income) for the estimated future tax consequences of temporary differences.

5 Temporary differences arise when the accounting treatment and the tax treatment for a transaction differ in a given year, and create a difference between the carrying amount of an asset or a liability in the financial statements and its tax base.
IFRSs might require assets (or liabilities) to be measured at something other than depreciated cost – such as fair value or current value. However, for tax purposes the tax base of the underlying assets (liabilities) might not be adjusted, or the adjustment might be for a different amount than that reflected in the IFRS financial statements.

Under IAS 12, deferred tax liabilities are measured on a basis that reflects the manner in which the entity expects to recover the underlying asset that will generate the future tax expense in a future period.

In some jurisdictions, an entity will pay income tax if it recovers an asset by using it in its operations, but will not pay income tax if it recovers the asset through sale. Typically, this will occur in jurisdictions that ‘tax’ the profits generated by using an asset (for example, by earning rental income), but do not tax the gain realised if the asset is sold. In this case:

(a) if an entity expects to recover the asset only through use, it recognises a deferred tax liability.

(b) if an entity expects to recover the asset only through sale, it recognises no deferred tax liability.

The issue

An entity might ‘recover’ the carrying amount of an investment property by using the asset for a period of time (to earn rental income) and then sell it subsequently. In such cases, the carrying amount of the investment property will be recovered in two different ways and may be taxed based on different tax rates. Specifically, the Amendments apply to investment property measured at fair value under IAS 40 Investment Property.

Some entities may not have a current intention to sell the investment property, but this may change depending on market conditions or other events. Accordingly, management’s expectation is that investment properties are held for an indeterminate period.

Under IAS 12, the calculation of deferred tax should reflect the underlying ‘dual’ purpose of recovery of the asset. However, the standard does not provide specific guidance on how this should be done, and how a ‘dual’ measurement approach should be applied.

What has changed?
The rebuttable presumption

The Amendments note that it is often difficult and subjective to determine the expected manner of recovery. To provide a practical approach in such cases, the Amendments introduce an exception to the measurement principle in IAS 12 in the form of a rebuttable presumption that assumes that the carrying amount of an investment property measured at fair value will be recovered through sale and an entity will be required to use the tax rate applicable to the sale of underlying asset.

The Amendments do not apply to other types of assets such as tangible assets and intangible assets measured under the revaluation model or financial assets measured at fair value.

In some cases, an entity might recover the fair value of a depreciable investment property measured at fair value by consuming its economic benefits over its useful life. The IASB acknowledged that in such cases it would not be appropriate to assume that the asset will be ‘recovered’ through sale, because the accounting outcome of using
the exception in those cases would not reflect the real tax consequences of recovering the asset. An entity is required to rebut the presumption if the investment property is depreciable and 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.

When do the Amendments become effective?

15 The Amendments are effective for annual periods beginning on or after 1 January 2012. Earlier application is permitted. If an entity applies the Amendments from an earlier date, it shall disclose that fact.

EFRAG’s initial analysis of the costs and benefits of the Amendments

16 EFRAG carried out an initial assessment of the costs and benefits expected to arise for preparers and for users from implementing the Amendments, both in year one and in subsequent years. The results of EFRAG’s initial assessment can be summarised as follows:

(a) Costs – EFRAG’s initial assessment was that the Amendments would not significantly affect the costs for preparers and users.

(b) Benefits – EFRAG’s initial assessments was that users were likely to benefit from the Amendments because the information provided is likely to be less subjective and therefore enhance comparability of information. However, there are no benefits to users in the rare cases where the Amendments are likely to result in information that is not relevant.

17 EFRAG published its initial assessment and supporting analysis on 18 November 2011 and invited comments on the material by 18 December 2011. In response, EFRAG received nine comment letters. Seven respondents agreed with EFRAG’s assessment of the benefits of implementing the Amendments and the associated costs involved for users and preparers. One respondent disagreed with the assessment and one did not comment on EFRAG’s initial assessment of the costs and benefits of implementing the Amendments in the EU.

EFRAG’s final analysis of the costs and benefits of the Amendments

18 EFRAG’s detailed final analysis of the costs and benefits of the Amendments is presented in the paragraphs below and takes into account the initial analysis and stakeholders’ views on that analysis.

Cost for preparers

19 EFRAG has carried out an assessment of the cost implications for preparers resulting from the Amendments.

20 Entities holding investment property at fair value, with the intention to rent them out for a period of time and then sell them, previously had to consider the tax consequences of both use and sale when measuring deferred taxes. In some cases preparers find it difficult to determine the manner of recovery of investment property in dual use scenarios.

21 The rebuttable presumption provides relief to those preparers and requires them to consider a single manner of recovery of the carrying amount of investment property held at fair value. For these preparers the Amendments are likely to result in an overall reduction of costs both upon the implementation phase and on an on-going basis.
Some preparers will be required to assess whether the carrying amount of the investments property held will be consumed through use over time, rather than through sale. Existing IAS 12 requires an entity to assess the manner in which it expects to recover investment property. This assessment also requires a degree of judgement and involves a similar level of administrative burden. Therefore, the Amendments are unlikely to increase the administrative burden significantly for entities that have previously been able to establish how they expect to recover investment property carried at fair value.

As such, EFRAG’s assessment is that the Amendments will not significantly affect the costs for preparers.

**Costs for users**

EFRAG has carried out an assessment of the cost implications for users resulting from the Amendments.

Users are expected to incur some incremental costs to incorporate the new requirements, resulting from the Amendments, into their analysis.

EFRAG believes that there are two factors to consider:

(a) The reduction in the degree of subjectivity when an entity applies the exception is likely to provide users with information that is more comparable and, as a result, generate cost savings to users.

(b) If the relevance and comparability of information is adversely affected by requiring entities to produce financial information on a basis that does not reflect actual fact, users may need to perform additional work to understand the tax position of those entities.

Overall, EFRAG’s assessment is that the Amendments will not significantly affect the costs for users.

**Benefits for preparers and users**

EFRAG has carried out an assessment of the benefits for preparers and users resulting from the Amendments.

EFRAG’s assessment is that the Amendments will result in benefits for those preparers that will use the exemption, while other preparers remain unaffected.

Users are also likely to benefit from the Amendments to the extent that the information they obtain is less subjective, and as a result more reliable.

However, as explained above, there are no benefits to users in the rare cases where the Amendments result in information that is not relevant.

**Conclusion**

Overall, EFRAG’s assessment is that the benefits to be derived from implementing the Amendments are likely to outweigh the costs involved.
Attachment 2: Endorsement advice prepared by the European Financial Reporting Advisory Group (EFRAG)

Jonathan Faull  
Director General  
European Commission  
Directorate General for the Internal Market  
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19 January 2012

Dear Mr Faull

Adoption of Deferred Tax: Recovery of Underlying Assets (Amendments to IAS 12)

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards we are pleased to provide our opinion on the adoption of Deferred Tax: Recovery of Underlying Assets (Amendments to IAS 12) (‘the Amendments’), which were issued by the IASB on 20 December 2010. It was issued as an Exposure Draft in September 2010 and EFRAG commented on that draft.

The objective of the Amendments is to introduce an exception to the measurement principle in IAS 12 in the form of a rebuttable presumption that assumes that the carrying amount of an investment property measured at fair value will be recovered through sale and an entity will be required to use the tax rate applicable to the sale of underlying asset.

The Amendments become effective for annual periods beginning on or after 1 January 2012. Earlier application is permitted, however entities shall disclose that fact.

EFRAG has carried out an evaluation of the Amendments. As part of that process, EFRAG issued an initial assessment for public comment and, when finalising its advice and the content of this letter, it took the comments received in response into account. EFRAG’s evaluation is based on input from standard setters, market participants and other interested parties, and its discussions of technical matters are open to the public.

EFRAG supports the Amendments and has concluded that they meet the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards in that they:


- meet the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.
For the reasons given above, EFRAG is not aware of any reason to believe that it is not conductive to the European public good to adopt the Amendments, and accordingly, EFRAG recommends their adoption. EFRAG's reasoning is explained in the attached 'Appendix - Basis for Conclusions'.

On behalf of EFRAG, I should be happy to discuss our advice with you, other officials of the EU Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely

François Flores
EFRAG Chairman
APPENDIX 1

BASIS FOR CONCLUSIONS

This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG on Deferred Tax: Recovery of Underlying Assets (Amendments to IAS 12) (‘the Amendments’).

In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG’s capacity as a contributor to the IASB’s due process. They do not necessarily indicate the conclusions that would be reached by EFRAG in its capacity of advising the European Commission on endorsement of the definitive IFRS in the European Union and European Economic Area.

In the latter capacity, EFRAG’s role is to make a recommendation about endorsement based on its assessment of the final IFRS or Interpretation against the technical criteria for European endorsement, as currently defined. These are explicit criteria which have been designed specifically for application in the endorsement process, and therefore the conclusions reached on endorsement may be different from those arrived at by EFRAG in developing its comments on proposed IFRSs or Interpretations. Another reason for a difference is that EFRAG’s thinking may evolve.

Does the accounting that results from the application of the Amendments meet the criteria for EU endorsement?

1 EFRAG has considered whether the Amendments meet the requirements of the European Parliament and of the Council on the application of international accounting standards, as set out in Regulation (EC) No 1606/2002, in other words that the Amendments:

(a) are not contrary to the ‘true and fair’ set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and

(b) meet the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

EFRAG also considered, based only on evidence brought to its attention by constituents, whether it would be conducive to the European public good to adopt the Amendments.

Relevance

2 Information is relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or by confirming or correcting their past evaluations.

3 EFRAG considered whether the Amendments would result in the provision of relevant information – in other words, information that has predictive value, confirmatory value or both – or whether it would result in the omission of relevant information.

4 The Amendments introduce an exception in the form of a rebuttable presumption to the measurement principle in IAS 12. The Amendments require an entity to measure deferred tax on investment property carried at fair value, based on the tax consequences of selling that asset, unless an entity rebuts this presumption. This presumption is rebutted if the investment property is depreciable and 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. The Amendments are
intended to provide relief to entities that find it difficult to determine the manner of recovery of *depreciable* investment property measured at fair value, and thereby reduce subjectivity.

5 A fundamental principle in existing IAS 12 is to measure deferred taxes based on the manner in which an entity expects to recover the carrying amount of an asset. As explained below, the relevance of information produced under the Amendments is unaffected in most circumstances, because entities will rebut the presumption in paragraph 51C of the Amendments when it is appropriate to do so.

6 The information resulting from the application of the Amendments would be relevant in the following circumstances:

(a) When an entity has a clear expectation of recovering the carrying amount of the investment property through sale.

(b) If the investment property 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. In this case, the presumption would be rebutted and the measurement principle in IAS 12 would apply.

7 In EFRAG’s view, only in rare circumstances would an entity produce information that does not reflect the real tax consequences that are expected to arise when the underlying asset is recovered. Such circumstances might arise when an entity does not have sufficient evidence to rebut the presumption, even though it might be more appropriate to do so.

8 The IFRS Interpretations Committee discussed a request to clarify whether the presumption can be rebutted in cases other than the case described in paragraph 51C of the Amendments. As noted in the November 2011 IFRIC Update, the IFRS Interpretations Committee commented that a presumption is a matter of policy in applying a principle (or an exception) in IFRSs, which can be rebutted when there is sufficient evidence to overcome it. The Committee also noted that the Amendments do not preclude the presumption to be rebutted in circumstances other than those in paragraph 51C. On this basis, the Committee decided not to take the issue to its agenda.

9 EFRAG agrees that the Amendments do not provide an exhaustive list of cases in which the presumption in paragraph 51C can be rebutted and do not preclude the presumption from being rebutted in other cases. Furthermore, if the presumption is rebutted, an entity must apply the measurement principles in IAS 12.

**Conclusion**

10 For the reasons stated above, EFRAG’s assessment is that the Amendments satisfy the relevance criterion.

**Reliability**

11 EFRAG also considered the reliability of the information that will be provided by applying the Amendments. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent, and is complete within the bounds of materiality and cost.
There are a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation, and completeness.

Under the existing IAS 12, in the absence of specific plans to dispose of an investment property, an entity is required to estimate the portion of its carrying value that is expected to be recovered through future cash flows from use (for example rental income) and the portion that is expected to be recovered through cash flows from its sale. In some cases, it is difficult to undertake this exercise, given the degree of subjectivity involved in assessing future recovery of an asset.

The Amendments aim to reduce the subjectivity by shifting the focus away from the notion of ‘manner of recovery’ for investment property measured at fair value, and introducing a single measurement approach that provides relief to entities that find it difficult to determine the manner of recovery of investment property. This approach does not involve significant judgements or estimates, and would not raise any significant issues with regard to freedom from material error and bias, faithful representation or completeness.

Conclusion

For the reasons stated above, EFRAG’s assessment is that the Amendments satisfy the reliability criterion.

Comparability

EFRAG has considered whether the Amendments result in transactions that are:

(a) economically similar being accounted for differently; or

(b) transactions that are economically different being accounted for as if they are similar.

As explained above, the Amendments introduce a single measurement approach to calculate deferred tax on investment property measured at fair value. Therefore, the measurement of deferred tax balances of like investment properties held at fair value would be accounted for in a consistent way.

However, in the rare cases identified in paragraph 7 above, where information produced by the Amendments is not relevant, the information would represent transactions as similar when they are not.

Conclusion

For the reasons stated above, EFRAG’s assessment is that the Amendments satisfy the comparability criterion.

Understandability

The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and
economic activity and accounting and the willingness to study the information with reasonable diligence.

22 Although there are a number of aspects to the notion of ‘understandability’, EFRAG believes that most of the aspects are covered by the discussion above about relevance, reliability and comparability.

23 As a result, EFRAG believes that the main additional issue it needs to consider, in assessing whether the information resulting from the application of the Amendments is understandable, is whether that information will be unduly complex.

24 As previously explained the Amendments aim to provide relief to those entities that find it difficult to determine the manner of recovery of investment property measured at fair value, and do not introduce new accounting requirements.

**Conclusion**

25 EFRAG’s assessment is that the Amendments do not introduce any new complexities that may impair understandability and therefore satisfies the understandability criterion.

**True and Fair**

26 EFRAG has concluded that the information resulting from the application of the Amendments would not be contrary to the principle of true and fair view.

**European public good**

27 EFRAG is not aware of any reason to believe that it is not conducive to the European public good to adopt the Amendments.

**Conclusion**

28 For the reasons set out above, EFRAG’s assessment is that the Amendments satisfy the technical criteria for EU endorsement and EFRAG should therefore recommend its endorsement.

29 As explained in Appendix 2, one EFRAG TEG member has concerns with the Amendments that cause that member to believe that EFRAG should not recommend the Amendments for endorsement.
APPENDIX 2
DISSENTING OPINION

1 Andy Simmonds (EFRAG TEG member) dissents from recommending endorsement of
Deferred Tax: Recovery of Underlying Assets (Amendments to IAS 12) (‘the
Amendments’).

2 Andy Simmonds believes that the Amendments should not be endorsed for use in the
European Union and therefore dissents from EFRAG’s decision to recommend its
endorsement. Andy Simmonds has reached this conclusion because he believes
aspects of the Amendments do not meet the criteria for endorsement. In particular:

(a) Paragraph 51C of the amended IAS 12 requires that, in measuring deferred tax
on an investment property carried at fair value, there is a rebuttable presumption
that the carrying amount of the investment property will be recovered through
sale. In Andy Simmonds view, this presumption of recovery through sale is
unnecessary, and may result in measurement of tax at an amount which is
misleading.

(b) As IASB note in paragraph BC8 to the Amendments, IAS 12 includes a 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.
Paragraph BC8 further notes that in many cases, 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. Andy Simmonds believes that the
principle is adequate to deal with investment property which is used and then
sold, and should result in deferred tax that reflects a period of use followed by
sale. In practice, the resulting amount of deferred tax may be the same as that
based on an assumption of sale. In such cases the Amendments are
unnecessary, and promote a rule-based approach at the expense of principles.

(c) In cases where the resulting amount of deferred tax under the Amendments
differs from the tax based on an assumption of use followed by sale, as occurs in
the ‘Example illustrating paragraph 51C’, the deferred tax calculated under the
Amendments will not represent a best estimate of future cash flows and may thus
be misleading.