

# INTERNATIONAL FINANCIAL REPORTING BULLETIN 2011/01

## DEFERRED TAX: RECOVERY OF UNDERLYING ASSETS



### Background

The measurement of deferred tax in accordance with IAS 12 *Income Taxes* is based on the principle that this should reflect the tax consequences that follow from the manner in which an entity expects to recover or settle the carrying amount of its assets and liabilities. For assets, this requires consideration of whether the entity will recover the carrying amount through sale, or by consumption of the asset through its use with an associated depreciation or amortisation charge being recorded in profit or loss.

However, investment property presents particular difficulties as, in many cases, an entity expects to rent out investment property for a period to earn rental income and then sell it, to benefit from capital appreciation. Without specific plans for the timing of disposal of investment property, it is difficult and subjective to estimate how much of the carrying amount of an investment property, at a reporting date, will be recovered through cash flows from rental income and how much will be recovered through cash flows from selling the asset.

The issue for investment property is particularly acute where it is measured at fair value. This is because these investment properties are not depreciated to a residual amount; in contrast, where investment property is measured using the cost model, the estimates that are 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 its depreciable amount, and through sale to the extent of its residual value.

In order to address the issue arising for investment property measured using the fair value model, the IASB has amended IAS 12 by introducing an exception to the principle of measuring deferred tax through reference to the expected manner of recovery of the asset. The purpose of the exception is to require the manner of recovery of the carrying amount of an entity's investment property to be reflected in a practical way that involves little subjectivity.

As a result of the amendments SIC-21 *Income Taxes – Recovery of Revalued Non-Depreciable Assets*, which would no longer have applied to investment property measured using the fair value model, has been withdrawn. The remaining guidance in SIC-21 has been incorporated into IAS 12 itself.

### STATUS

Final

### EFFECTIVE DATE

Annual periods commencing on/after 1 January 2012. Earlier application permitted.

### ACCOUNTING IMPACT

May be significant for entities that measure investment property at fair value

## Requirements

### Investment property measured at fair value

If a deferred tax liability or deferred tax asset arises from investment property that is measured using the fair value model in IAS 40 *Investment Property*, there is a rebuttable presumption to be applied for the purposes of the deferred tax calculation that the carrying amount of the investment property will be recovered through sale. It is noted in the Basis for Conclusions that even if an entity derives rental income from an investment property through its rental in a given period, the value of the future earnings capacity of the investment property will often not decrease, meaning that its reporting date carrying amount will ultimately be realised through sale.

The presumption of recovery through sale 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. It is noted in the Basis for Conclusions that:

- The presumption of recovery through sale cannot be rebutted if the asset is non-depreciable because that implies that no part of the reporting date carrying amount of the asset will be consumed through use; and
- The term 'business model' has been used because it is already used in IFRS 9 *Financial Instruments*, and does not depend on management's intentions for a single asset.

If the presumption of recovery through sale is rebutted, the normal deferred tax accounting requirements of IAS 12 are followed. Worked examples are included with the amendments to illustrate the application of the new requirements.

### Business combinations – investment property measured at fair value

The rebuttable presumption of recovery through sale also applies when a deferred tax liability or a deferred tax asset arises in the consolidated financial statements of an acquirer from the acquisition of investment property in a business combination. As with stand alone entities, this applies only where the acquirer will use the fair value model when subsequently measuring the investment property.

### Non-depreciable assets measured using the revaluation model in IAS 16 Property, Plant and Equipment

Following the withdrawal of SIC-21, the remaining guidance for assets within the scope of IAS 16 *Property, Plant and Equipment* has been incorporated into IAS 12. If a deferred tax liability or a deferred tax asset arises from a non-depreciable asset (such as freehold land) measured using the revaluation model in IAS 16, the measurement of the deferred tax liability or deferred tax asset is required to reflect the tax consequences of recovering the reporting date carrying amount of the non-depreciable asset through sale, regardless of how the revalued carrying amount of the asset has been determined.

This means that if the tax rate that is applicable to taxable amounts derived from the sale of an asset differs from the tax rate that is applicable to taxable amounts derived from the use of an asset, the former (sale) rate is applied in measuring the related deferred tax liability or deferred tax asset.

## Effect

The exception to the principles of IAS 12 that is introduced by the amendments represents a practical approach for measuring deferred tax liabilities and deferred tax assets, as it is frequently difficult and subjective to determine the expected manner of recovery of an investment property which is measured at fair value.

The amendments are likely to be particularly relevant to entities in Hong Kong, and may also be relevant to entities in other jurisdictions such as Singapore, New Zealand, South Africa and the United Kingdom. This is because, in these jurisdictions, there is either no capital gains tax, or the rates/reliefs are different for capital gains tax in comparison with income tax.

However, it should be noted that the amendments do not appear to address issues arising from items of property, plant and equipment held by entities in New Zealand. The IASB discussed this point at a Board meeting held on 3 December, at which it was suggested that it could be dealt with either by a further, separate amendment or at the time of a more fundamental review of IAS 12.

## Effective date and transition

The amendments are required to be applied for annual periods commencing on or after 1 January 2012. Earlier adoption is permitted, with disclosure being required if this approach is taken.

The amendments are required to be applied retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates, and Errors*.

## Action required

For those entities that hold investment property in jurisdictions where the amendments are relevant, the measurement of deferred tax liabilities and deferred tax assets is likely to be affected. Management should therefore consider the implications of the amendments at an early stage, including:

- whether the amendments should be adopted early for 2010 year end reporting (note: this will only be available for entities that report in accordance with IFRS as issued by the IASB; other entities will need to establish whether where the amendments have been incorporated into either their converged local GAAP, or incorporated into EU-endorsed IFRS); and
- the effect of the amendments on business combinations that took place in previous reporting periods and involved the acquisition of investment property.

This publication has been carefully prepared, but it has been written in general terms and should be seen as broad guidance only. The publication cannot be relied upon to cover specific situations and you should not act, or refrain from acting, upon the information contained therein without obtaining specific professional advice. Please contact your respective BDO member firm to discuss these matters in the context of your particular circumstances. Neither BDO IFR Advisory Limited, Brussels Worldwide Services BVBA, BDO International Limited and/or BDO member firms, nor their respective partners, employees and/or agents accept or assume any liability or duty of care for any loss arising from any action taken or not taken by anyone in reliance on the information in this publication or for any decision based on it.

Service provision within the international BDO network of independent member firms ('the BDO network') in connection with IFRS (comprising International Financial Reporting Standards, International Accounting Standards, and Interpretations developed by the IFRS Interpretations Committee and the former Standing Interpretations Committee), and other documents, as issued by the International Accounting Standards Board, is provided by BDO IFR Advisory Limited, a UK registered company limited by guarantee. Service provision within the BDO network is coordinated by Brussels Worldwide Services BVBA, a limited liability company incorporated in Belgium with its statutory seat in Brussels.

Each of BDO International Limited (the governing entity of the BDO network), Brussels Worldwide Services BVBA, BDO IFR Advisory Limited and the member firms is a separate legal entity and has no liability for another such entity's acts or omissions. Nothing in the arrangements or rules of the BDO network shall constitute or imply an agency relationship or a partnership between BDO International Limited, Brussels Worldwide Services BVBA, BDO IFR Advisory Limited and/or the member firms of the BDO network.

BDO is the brand name for the BDO network and for each of the BDO member firms.

© 2011 BDO IFR Advisory Limited, a UK registered company limited by guarantee. All rights reserved.

[www.bdointernational.com](http://www.bdointernational.com)