REPUBLIC OF ESTONIA
MINISTRY OF FINANCE

IFRS Interpretations Committee
IFRS Foundation
Columbus Building
7 Westferry Circus
London
E14 4HD

20 April 2020

Comments on the tentative agenda decision: Accounting for deferred tax in respect of undistributed profits in the subsidiaries in tax regimes where income tax is payable upon distribution rather than profit

Dear members of the IFRS Interpretation Committee,

We would like to thank you for discussing our original request during your March meeting. Based on the public recording of the meeting and tentative agenda decision it appears that at that stage the majority of the Committee members lean towards view 2 of the original paper. Following your invitation for comment and having discussed this topic further with the market participants, we would like to bring to your attention some further examples that highlight the peculiar consequences of applying this view in practice.

Both examples provided in this letter are quite common in practice, especially in the context of capital market transactions and acquisitions. The examples illustrate how setting up a holding company or merging it with the operating company can cause recognition of huge amounts of deferred tax expense or income that are difficult to justify by economic substance as nothing has changed in the actual taxes payable by those entities.

We would appreciate your comments on whether in the context of those examples you believe that application of the accounting treatment based on view 2 would meet the objectives and fundamental qualitative characteristics in the Conceptual Framework (especially faithful presentation, comparability and understandability), and if not, whether application of true and fair override (IAS 1.20) could be considered appropriate in the circumstances. Furthermore, in case the Interpretation Committee shares our concerns about the unwished consequences of applying current guidance in IAS 12 for distribution-based tax regimes, we would highly appreciate any initiatives to amend the guidance to make it consistent regardless of whether the profit is accumulated in a standalone entity, in a parent or in subsidiaries.

Yours sincerely,

Sander Kallasmaa

Chairman of the Estonian Accounting Standards Board (easb@fin.ee)

Examples about deferred tax consequences of applying view 2 in practice

We have described below two scenarios that are rather common in the context of capital market transactions and acquisitions. In both cases, the changes in the group structure will have no impact on the actual amounts of taxes payable. However, in case view 2 is believed to be the right interpretation of the existing literature, the changes in the legal structure will have extreme impact on deferred tax recognition or derecognition, not reflecting the economic consequences of the transactions.

<u>Example 1 - setting up a new holding company</u>

Company A is a stand-alone operating entity without any subsidiaries. Therefore, it does not recognize any deferred tax in respect of its accumulated profits in line with IAS 12.52A.

In order to prepare for a capital market transaction (eg IPO or bonds issue), the owners decide to set up a new holding company H at the top of the operating entity that will issue securities to the investors. As a result, the entity becomes a group, consisting of empty holding company H and an operating entity A.

Setting up a holding company has no impact on actual taxes payable by the entity as both before and after 20% of tax is payable on any dividends distributed to the shareholders. Distributing accumulated profits from A to H will not cause any additional tax expense, as dividends are taxed only once – dividends that are taxed at the moment of distribution from A to H are not further taxed when they are distributed to the shareholders.

While there is no impact on actual tax position, there is a severe impact on deferred tax recognition. As by setting up the holding company the entity becomes a ‘group’, it has to recognize deferred tax in respect of all the historically accumulated retained earnings in entity A (assuming view 2 is applied). This amount can be many times larger than the annual profit of A and it would be reflected as one off deferred tax expense in the new 'group', distorting fully its financial results. Setting up a holding company may lead to reduction of equity by up to 20% (in case most of A’s equity consists of retained earnings) making it incomparable with other similar entities without holding company that are subject to the same taxation.

<u>Example 2 - merging with the holding company</u>

Company B was acquired by new owners who used for that purpose a newly established holding company H. If view 2 is applied than deferred tax shall be recognised in the purchase price allocation exercise in respect of all the historically accumulated retained earnings in B (this seems to be the case even if reverse acquisition accounting would be applied).

Some time after the acquisition (it can be in the same or in the following accounting periods), H will be merged with B as it often happens in that kind of transactions. At the moment of merger, H-B group ceases to be a 'group' and becomes standalone entity again, resulting in the derecognition of the previously recognised deferred tax liability through the income statement. Like in the first example, it can be a huge amount, distorting the financial results and increasing the equity of B for 'no reason' by up to 20%, making it incomparable with other market participants. Similarly to the first scenario, neither the acquisition of B by H nor the subsequent merger changed anything in the actual taxes payable by the entity and the sudden deferred tax income and increase of equity would be hardly understandable for the users of the financial statements.

As both scenarios illustrate, the deferred tax accounting under view 2 would be purely based on the number of legal entities (ie whether the profit is accumulated in a standalone entity, parent or subsidiary) having no correlation with economic reality and actual taxes payable. From the taxation perspective, accumulated profits in the subsidiaries are treated exactly in the same way as accumulated profits in the parent - in both cases the same amount of tax is payable and **moving accumulated profits from the subsidiary to the parent via dividends does not cause any extra cost for the owners** (it only affects the moment of tax payment). However, if view 2 is believed to be the correct interpretation of IAS 12 then deferred tax accounting for accumulated profits in the subsidiary (where deferred tax is recognised immediately) is drastically different from deferred tax accounting for accumulated profits in the parent or standalone entity (where no deferred tax is recognised until dividends are declared), causing illogical inconsistencies that can hardly be substantiated by economic substance.

In the context of the two practical and common scenarios illustrated above, we would appreciate the comments of the Interpretation Committee on:

1) how such accounting treatment would meet the objectives and fundamental qualitative characteristics in the Conceptual Framework (especially faithful presentation, comparability and understandability); and
2) whether application of true and fair override (IAS 1.20) could be considered appropriate in the circumstances.

In case the Interpretation Committee shares our concerns about the current guidance in IAS 12 for distribution-based tax regimes (especially whether it meets the objectives and qualitative characteristics in the Conceptual Framework), we would highly appreciate any initiatives to amend the guidance and make it consistent regardless of whether the profit is accumulated in a standalone entity, in a parent or in subsidiaries.