

Investment property and accounting for deferred tax under IAS 12

A revised IFRS 3 “Business Combinations” was issued by the IASB in January 2008, with endorsement for use in the European Union pending. The revised standard is effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 July 2009, and amends the definition of a business, which requires consideration when assessing whether acquisitions of entities owning real estate are to be accounted for as business combinations rather than as asset deals. In addition, the IASB is working on a replacement to IAS 12 “Income Taxes”. An exposure draft is expected at a later stage. Dated December 2008, the below analysis is valid until superseded by any new or amended IFRS becoming effective, and does not reflect the revised IFRS 3 or any proposed replacement to IAS 12.

Introduction

Accounting for deferred tax is a complex issue in the investment property industry and involves judgement dependent on the specific facts and circumstances. This paper deals with some of the more frequently encountered issues and suggests practical solutions. Where many transactions are done with the property in a legal shell (wrapper), the central issue is whether the transaction is an asset deal¹ or a business combination. Under the present IAS 12, this results in different accounting for deferred tax and consequently has a significant effect on goodwill and impairment. An asset deal may result in a “day one” profit when the investment property (generally acquired for a price that reflects a portion of the tax deferral) is subsequently brought to its fair value. In a business combination, goodwill may arise as a consequence of the fact that IAS 12 requires the deferred tax liability to be measured at an undiscounted value, which may give rise to subsequent impairment issues.

This paper is based on the assumption that the investment property is measured at fair value under the choice available in IAS 40. Deferred tax issues may also arise when the cost model is used but this generally does not create such complex issues as those found under the fair value model. The analysis is from the perspective of a group’s consolidated financial statements, rather than an entity’s standalone financial statements.

As this is summarised information, it should not be relied on without reading the literature itself and/or seeking professional advice.

Background

IAS 12 requires accounting for deferred tax based on temporary differences between the carrying value of an asset or liability and its tax base.² Fair value measurement of investment property is likely to create differences between the accounting base and the tax base. In some countries the tax legislation for investment properties may be quite different from the normal taxation regime for other activities. Different amounts of tax, or no tax at all, may arise depending on the way transactions are legally structured. The investment property industry structures property acquisitions and disposals in a tax efficient manner. In practice this often involves the transfer of a legal shell (wrapper) that holds the property. This may even be the case for other reasons such as avoiding the registration of changes in ownership in public records such as the land register or avoiding the need to renegotiate lease contracts. The wrapper owning the property thus creates flexibility for its owner to structure a sale by means of an asset or a share deal, whichever the most beneficial at a given point in time.

Application in practice

In most situations the carrying value of investment property will be realised by a combination of income (rental stream during the period of use) and capital (the consideration on the sale at the end of use). Where different tax rates exist for income and capital gains, the entity has to consider the planned recovery of the asset and how that affects the tax rate and the tax base used in the calculation of the deferred tax.

It is important to note that for a property acquisition which is not a business combination and, at the time of initial recognition, affects neither accounting profit nor taxable profit, no deferred tax is recognised because the initial recognition exemption in IAS 12 paragraph 15(b) applies. The initial recognition exemption is considered below in practical example 5.

The first step is therefore to decide whether or not the transaction is a business combination or an asset acquisition to which the initial recognition exemption applies. Where the initial recognition exemption does not apply, an entity's approach would include the following steps:

1. Ascertain the expected manner of recovery of the asset's carrying amount.
2. Split the asset's carrying amount between amounts to be recovered through use and sale.
3. Determine the expected period of recovery through use and the expected date of sale.
4. Determine the temporary differences and the tax consequences arising from recovery through use.
5. Determine the temporary differences and the tax consequences arising from recovery through sale.
6. Determine which of the temporary differences arising from recovery through use and sale should be recognised.
7. Calculate the deferred tax asset or liability at the appropriate rate.

The temporary differences arising from the analysis in steps 4 and 5 above should be considered separately, rather than determining a net temporary difference if the taxable income or tax deductible amounts arising on reversal cannot be offset. Such offset may not be possible if under the relevant tax system income and capital gains are taxed in a different manner (for example, income and capital gains may not be fully offset); or if they are taxed at a different time (for example, a tax loss arising on the

reversal of a deductible temporary difference may not be offset against taxable income arising from the earlier reversal of a taxable temporary difference).

Note that the calculations should be based on the circumstances applicable to each individual asset. IAS 12 requires the use of the individual asset as the unit of account. However, the entity might be able to combine individual assets for the purposes of the calculation where the circumstances for each of the assets (including the period of expected use and sale) are the same. SIC-21 "Income Taxes—Recovery of Revalued Non-Depreciable Assets" requires that deferred tax relating to land be calculated on the basis of recovery of the carrying amount through sale. The recovery of the carrying value of a building may need to be split into the parts recovered by use and by sale (the "blended rate" approach).

It should be noted that under IAS 12, in consolidated financial statements temporary differences are determined by comparing the carrying amounts of assets and liabilities in the consolidated financial statements with the appropriate tax base. In relation to a property, the tax base is the amount attributed to the property for tax purposes. When the property is held by a subsidiary of a parent company, it would never be appropriate in the parent's consolidated financial statements (whether the transaction is treated as a business combination or an asset acquisition) to determine the tax base based on the cost of the shares in the subsidiary.

Some practical examples

The remainder of this paper deals with the following more common practical examples:

1. The entity lacks information to use the blended rate
2. The entity is a "REIT"
3. The entity is exempted from tax upon profits distributed
4. Indexation relief on capital gains
5. Investment property acquired in a wrapper

1. The entity lacks information to use the blended rate

Using the blended rate requires detailed assumptions about the way in which the individual assets will be recovered and the timing of that recovery. Where such information is not available, for example because the entity has no plans to sell and no history of selling, the entity needs to use the assumption that the recovery will be through continued use. This would mean that the income rate is used.

The calculation of the deferred tax liability is straightforward in these cases, but it is also very likely that the deferred tax liability may not represent the tax payable in the future.

2. The entity is a “REIT”

In some countries entities can have the status of a Real Estate Investment Trust (REIT) or similar, which exempts both the rental income and the capital gains on disposal of the investment property from corporate income tax. In such cases, the tax rate to be used would be that applicable to a REIT (normally zero) and deferred tax needs to be recognised based on the rate applicable for the REIT. Special attention is required for the accounting for the deferred tax and the conversion payment on the conversion of an entity into a REIT.

3. The entity is exempted from tax upon profits distributed

In some countries, investment property funds are facilitated for tax purposes in a kind of “pass through” system: tax is only levied at the shareholder level and the entity does not have to pay tax when the profit is distributed. The tax rate to be used would depend on the factual circumstances. For example, if the pass through is required by law, neither the entity nor the shareholder would have a choice and no tax would arise at the entity level. However, where the distribution requires a shareholder’s resolution to decide whether or not profits will be passed, and in what amount, deferred tax may need to be recognised. For the part that is subject to the shareholder’s decision, a tax liability will exist at the balance sheet date when the decision has not yet been taken as of that date. Differences may also exist where for example the pass through regime only applies to capital gains but not to rental income, or only applies to a proportion of the annual results.

4. Indexation relief on capital gains

In some countries, the rate of tax on sale and use is the same, but the tax base on sale is often higher because of the benefit of indexation relief. In practice, an entity may plan to use a property for a number of years and then sell it. In that situation, as the property’s basis of recovery is both through use and eventual sale, the deferred tax should reflect this expected manner of recovery. It is provided on the basis of normal income tax rules for the portion of the property’s carrying amount expected to be recovered through use and it is provided using capital gains tax rules in respect of the remainder of the property’s carrying amount expected to be recovered through sale. The blended approach would be used and for the part that is recovered through sale, the tax base

would be the amount adjusted for the indexation relief. Only the indexation that has occurred through the balance sheet date can be considered; any possible future indexation is not taken into account.

5. Investment property acquired in a wrapper

One of the more important features for the real estate industry in respect of the accounting for deferred tax is the initial recognition exemption in IAS 12 paragraph 15(b), which applies for property acquisitions outside a business combination. The first step is therefore to decide whether or not the transaction is a business combination or an asset acquisition. Property transactions vary significantly in terms of the nature of the underlying assets and the service provision contracts that are acquired. It is not possible to define a trigger point at which the transaction becomes a business combination as opposed to an asset transaction. However, there is a scale within which property transactions fall. At one end is a simple vacant land plot or single-tenant property for which no services are included.

At the other end of the scale is an investment property company which includes a property administration capability (cleaning, security, rent and service charge collection etc.), a property/asset management capability (lease management, tenant strategy, marketing etc.), a property investment management capability (responsible for capital expenditure/allocation decisions and property acquisition and disposal etc.) as well as central corporate functions such as treasury, tax, finance etc. For further guidance, reference is made to IFRS 3.³

The effect of whether or not the transaction is a business combination or an asset deal can be demonstrated with the following examples.

Example 1. Wrapper acquisition is not a business combination

Assume that an investment property (IP) with a fair value of 100 is acquired through purchasing a wrapper for 90. The discount is the result of the seller and the buyer negotiating the price based on the fact that the property is in a wrapper and a tax liability of 20 (fair value of 100 minus the tax base in the wrapper of 50 at a tax rate of 40%) can be avoided. Therefore as long as the property is not disposed out of the wrapper the tax liability will never crystallize; as such the tax benefit of 20, at the date of the transaction, is split between the buyer and the seller. In the separate financial statements of the parent, both the tax base and the carrying value of the investment in subsidiary would be 90⁴ and no deferred tax would be recognised. In the group accounts, although at the point of acquisition there is a temporary difference of 40 (the

carrying value of 90 minus the tax base of 50), no deferred tax liability is recognised as this is prohibited by the initial recognition exemption in IAS 12 paragraph 15(b) (the transaction is not a business combination and affects neither accounting profit nor taxable profit at the time of the transaction).

At acquisition, the group records the following in its accounts:

Investment property (IP)	Dt 90	
Cash		Cr 90

At the next interim reporting date, the group needs to show the IP at its fair value of 100 and thus records:

Investment property	Dt 10	
Income statement – fair value change		Cr 10
Deferred tax expense	Dt 4	
Deferred tax liability		Cr 4 (40% of 10)

As a result, the IP is carried at its fair value of 100 in accordance with IAS 40. There is no deferred tax liability on the temporary difference at the point of acquisition due to the initial recognition exemption, and hence a “day one” profit arises. However, on the recognition of the adjustment to fair value, deferred tax is recognised as this adjustment affects profit and thus the initial recognition exemption does not apply to the incremental temporary difference of 10.

Assuming the fair value at the end of the year amounts to 120, the group only considers the temporary difference arising from the changes in fair value since the last reporting date, i.e. 20 (120 – 100) for the calculation of the deferred tax liability movement of 8 (20 at the rate of 40%), thus resulting in the following entries:

Investment property	Dt 20	
Income statement – fair value change		Cr 20
Deferred tax expense	Dt 8	
Deferred tax liability		Cr 8

The investment property is thus at its fair value under IAS 40 of 120 and the temporary difference of 70 (the carrying value of 120 minus its tax base of 50) consists of a part on which deferred tax is not recognised because of the initial recognition exemption, amounting to 40 (90 minus 50), and a part on which deferred tax is recognised at the tax rate of 40% on the fair value change after initial recognition, amounting to 30 (120 minus 90). The deferred tax liability is thus recognised and measured in accordance with the requirements of IAS 12.

Example 2. Wrapper acquisition is a business combination

Assume the same scenario as above, but the transaction is a business combination. In the separate financial statements of the parent both the tax base and the carrying value of the investment in subsidiary would be 90⁴ and no deferred tax would be recognised. In the group accounts, the investment property is recognised at its fair value of 100 and there is a temporary difference of 50 (the carrying value of 100 minus the tax base of 50), and a deferred tax liability is recognised at acquisition as this is required by IFRS 3 (the initial recognition exemption in IAS 12 paragraph 15(b) cannot be applied as the transaction is a business combination). The group therefore accounts for the full deferred tax liability of 20 (40% of 50, being the difference between the fair value of 100 and the tax base of 50), which results in goodwill of 10:

Investment property	Dt 100	
Goodwill	Dt 10	
Deferred tax liability		Cr 20
Cash		Cr 90

The investment property is thus at its fair value under IAS 40 of 100 and the deferred tax liability arises from the temporary difference of 50 (carrying value of 100 minus tax base of 50), being the full and undiscounted amount measured in accordance with the requirements of IAS 12. In accordance with IAS 36 the goodwill created will need to be tested for impairment annually.

¹ “Asset deal” or “asset acquisition” is used in this paper to refer to an acquisition of a subsidiary which does not meet the definition of a business under IFRS 3 “Business Combinations”. When an entity acquires a group of assets or net assets that does not constitute a business, it allocates the cost of the group between the individual identifiable assets and liabilities in the group based on their relative fair values at the date of acquisition.

² The tax base of an asset is the amount attributed to that asset for tax purposes.

³ IFRS 3 (as issued in 2004) defines a business as: *An integrated set of activities and assets conducted and managed for the purpose of providing:(a) a return to investors; or (b) lower costs or other economic benefits and proportionately to policy holders and participants. A business generally consists of inputs, processes applied to those inputs, and resulting outputs that are, or will be, used to generate revenues. If goodwill is present in a transferred set of activities and assets, the transferred set shall be presumed to be a business.*

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⁴ In practice the carrying value at initial recognition of the investment may include capitalised transaction costs, and hence be higher than the tax base, but this is ignored in the example to keep things simple.

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