Adoption of IFRSs by Investment Funds

Extract, IFRS Discussion Group Report on Meeting – December 2, 2013

The IASB's Investment Entities project was completed in 2012 with the issue of the amendments to IFRS 10 Consolidated Financial Statements, IFRS 12 *Disclosure of Interests in Other Entities* and IAS 27 *Separate Financial Statements*. These amendments require qualifying investment entities to measure particular subsidiaries at fair value through profit or loss, rather than consolidate them, and are effective for annual periods beginning on or after January 1, 2014.

The AcSB had deferred the adoption of IFRSs for investment companies and segregated accounts of life insurance enterprises that are publicly accountable enterprises, pending the completion of the IASB's Investment Entities project. After the IASB issued *Investment Entities* (Amendments to IFRS 10, IFRS 12 and IAS 27) in 2012, the AcSB confirmed that these entities must adopt IFRSs for interim and annual financial statements relating to annual periods beginning on or after January 1, 2014. As the changeover date to IFRSs for these entities approaches, a number of transition issues have arisen. The Group discussed some of these issues:

- accounting for income taxes by investment funds:
    - taxation of mutual fund trusts (Issue 1);
    - withholding taxes (Issue 2);
- calculation of interest income (Issue 3);
- application of IFRS 12 to investment funds:
    - the investment entity exemption (Issue 4); and
    - unconsolidated structured entities and "funds of funds" (Issue 5).

The above list is not exhaustive. Other issues may be encountered by investment funds on transition to IFRSs, including issues that the IFRS Interpretations Committee is currently considering.

Issue 1: Taxation of Mutual Fund Trusts[1]

In Canada, mutual fund trusts are not taxed on income earned in a taxation year, to the extent that such income has been distributed to unitholders prior to the end of the taxation year. Typically, the declaration of trust requires that the mutual fund trust distribute sufficient income to reduce any taxable income to nil and mandates an automatic distribution for any remaining undistributed taxable income at 11:59 pm on the last day of the taxation year. As a result, there is generally little possibility of the trust being taxable on ordinary income under Part 1 of the Income Tax Act.

[1] The meeting report on this issue contains additional details because the Group's discussion was not recorded due to a technician error.

Under pre-changeover Canadian GAAP, investment funds apply the guidance in Section 3465, Income Taxes, and EIC 107, Application of CICA 3465 to Mutual Fund Trusts, Real Estate Investment Trusts, Royalty Trusts and Income Trusts, in Part V of the CPA Canada Handbook – Accounting.

Paragraph 3465.83 states: "Taxes related to distributions or future distributions should be given the same accounting treatment as the distributions."

EIC 107 states: "… a tax deduction received by a trust for distributions to unitholders represents, in substance, an exemption from taxation of an equivalent amount of the trust's earnings."

Under pre-changeover Canadian GAAP, the mutual fund was permitted to record no income taxes when the conditions in that EIC are met.

Paragraphs 52A-B of IAS 12 *Income Taxes* states:

> "In some jurisdictions, income taxes are payable at a higher or lower rate if part or all of the net profit or retained earnings is paid out as a dividend to shareholders of the entity. In some other jurisdictions, income taxes may be refundable or payable if part or all of the net profit or retained earnings is paid out as a dividend to shareholders of the entity. In these circumstances, current and deferred tax assets and liabilities are measured at the tax rate applicable to undistributed profits.
>
> In the circumstances described in paragraph 52A, the income tax consequences of dividends are recognised when a liability to pay the dividend is recognised. The income tax consequences of dividends are more directly linked to past transactions or events than to distributions to owners. Therefore, the income tax consequences of dividends are recognised in profit or loss for the period as required by paragraph 58 except to the extent that the income tax consequences of dividends arise from the circumstances described in paragraph 58(a) and (b)."

The Group considered whether Canadian mutual fund trusts applying IFRSs are within the scope of IAS 12 and are required to record Canadian income taxes. Specifically, whether Canadian income taxes for these trusts can be considered, in substance, tax exempt (*View 1A*), or whether they must record these taxes based on the rate applicable to undistributed profits until the obligation to make such distributions arises (*View 1B*).

View 1A – The mutual fund trust is not required to record income taxes.

Under this view, mutual funds are not required to record Canadian income taxes under IAS 12 because they have an "in-substance" exemption. The declaration of trust legally obligates the entity to distribute income annually to unitholders such that it has no remaining income that could be taxable otherwise. The mutual fund trust has no discretion to avoid these distributions and consequently, there is little possibility of being taxable.

Under this view, similar conditions to those expressed in EIC 107 are applied to IFRSs to assess whether mutual funds have an "in substance" exemption from Canadian taxation and, as a result, paragraphs 52A-B of IAS 12 do not apply. In addition, paragraphs 52A-B of IAS 12 were designed for jurisdictions in which the distributed rate and undistributed rate both differ from zero and an entity may make an economic decision not to make distributions. (For example, when the distributed rate is 35 per cent and the undistributed rate is 40 per cent, an entity may decide to retain cash for expansion rather than distribute cash.)

View 1B – The mutual fund trust is taxable and should record income taxes.

Under this view, there is no basis to exempt mutual funds from IAS 12 because there is no equivalent to EIC 107 under IFRSs. The mutual funds are subject to Canadian taxation, but they reduce their taxation through paying distributions regardless of whether such distributions are contractually required to take place automatically. These trusts must record income taxes based on the rate applicable to undistributed profits until the obligation to make such distributions arises.

The Group's Discussion

Group members supported View 1A that the mutual funds have an "in substance" exemption from Canadian income taxation. Group members noted that this issue was discussed previously during the March 2010 meeting and similar views were expressed.

The Group did not recommend any further action be taken regarding this issue.

Issue 2: Withholding Taxes[2]

Mutual funds that hold foreign securities are often subject to withholding taxes on dividends and other income earned from those investments. Generally, the mutual fund would have no control, joint control or significant influence over the foreign investees. Under pre-changeover Canadian GAAP, the investment income is usually reported net and the amounts withheld are disclosed parenthetically on the statement of income. Paragraph 2 of IAS 12 states, in part: "Income taxes also include taxes, such as withholding taxes, which are payable by a subsidiary, associate or joint arrangement on distributions to the reporting entity."

The Group considered whether withholding taxes on income from foreign securities that are not subsidiaries, associates or joint arrangements are income taxes. Specifically, whether the foreign income is required to be presented gross with the amounts withheld shown separately as expense (View 2A) or can be presented on a net basis (*View 2B*) under IFRSs.

View 2A – Yes, separate presentation of gross foreign income and withholdings as income tax expense is required.

[2] The meeting report on this issue contains additional details because the introduction to the Group's discussion of this issue was not recorded due to a technician error.

Although they are arising from financial instruments, rather than subsidiaries, associates or joint arrangements, the withholding taxes on distributions from these investments are income taxes within the scope of IAS 12.

Paragraph 82 of IAS 1 *Presentation of Financial Statements* states: "… the profit or loss section or the statement of profit or loss shall include line items that present the following amounts for the period … tax expense…"

As a result, mutual funds should present foreign income on a gross basis and present withholding taxes as a separate line item.

In some cases, mutual funds may present additional subtotals that are relevant to an understanding of the fund's financial performance in accordance with paragraph 85 of IAS 1. Examples of such subtotals may include the increase (decrease) in net assets attributable to holders of redeemable units before income taxes, income taxes, and net increase (decrease) in net assets attributable to holders of redeemable units.

View 2B – No, income from foreign securities can be presented net of withholdings.

Investments in subsidiaries, associates and joint arrangements are part of the reporting entity. Withholding taxes incurred on distributions from these entities are part of the tax expense on the group's income overall. The investor is able to control, or at a minimum participate in, the decision about the timing and amount of such distributions giving rise to the withholding tax. In substance, the investor is, at least to some extent, operating and earning income that is being taxed in the foreign jurisdiction through withholdings on the distributions. As such, withholding taxes on distributions from these investments are reported as income taxes.

In contrast, the foreign securities are not part of the group. The investor has no input or ability to affect the amount and timing of distributions. The investor is only entitled to the net amount and not the portion of income being withheld. The investor should record income based on the net amount to which it is entitled, without separate recognition of the withholding taxes.

The Group's Discussion

Group members generally supported View 2A that separate presentation of gross foreign income and withholdings as income tax expense is required because the withholding taxes on distributions from these investments are income taxes within the scope of IAS 12.

One Group member questioned whether this view conflicts with View 1A that the mutual funds have an "in substance" exemption from taxation and, therefore, are not in the scope of IAS 12. Group members clarified that in Issue 1, the particular taxes (i.e., Canadian income taxes) are not within the scope of IAS 12 because of the mechanism in place for those taxes. In contrast, in this issue, the particular taxes (i.e., the foreign withholding taxes) are within the scope of IAS 12 because they are not subject to that mechanism.

The Group did not recommend any further action be taken regarding this issue.

Issue 3: Calculation of Interest Income

Investment funds typically account for all investments in financial assets, including debt instruments, at fair value through profit or loss. For debt instruments carried at fair value through profit or loss, IFRSs do not require interest income to be presented separately from other changes in the fair value of the investment. However, in Canada, Part 3.2(2) of National Instrument 81-106 *Investment Fund Continuous Disclosure* requires that interest income be presented as a separate line item on the statement of income.

The Group considered how to present interest income separately from other changes in fair value for financial assets carried at fair value through profit or loss. Specifically, do IFRSs require interest income to be calculated using the effective interest method in such circumstances?

The Group's Discussion

Group members noted that although paragraph 30 of IAS 18 requires interest income to be calculated using the effective interest method, this paragraph applies to the recognition and measurement of interest income. If a bond is being carried at fair value through profit or loss, interest income is recognized as part of the overall change in the fair value of the bond each period and paragraph 30 of IAS 18 does not apply. Further, IFRSs do not require interest income to be presented separately.

Group members observed that a conflict exists between IFRSs and the securities regulations in that the securities regulations require disclosure of interest income for assets that are accounted for at fair value through profit and loss. The majority of Group members supported the view that it is inappropriate to present a separate line item in the statement of profit or loss called "interest income" when the amount is not calculated in accordance with IFRSs (i.e., using the effective interest rate method).

One Group member questioned why interest income using the effective interest rate method specified by IFRSs cannot be calculated and disclosed to meet the securities requirements. Other Group members explained that the IFRS concept of effective interest differs fundamentally from measuring an asset at fair value through profit or loss. The difference between interest income determined on the IFRS effective interest rate method and the overall change in fair value of the interest-bearing assets would be a meaningless amount and possibly confusing to financial statement users if reported in a statement of profit or loss. Some Group members suggested different presentation and disclosure options to achieve both competing objectives (i.e., comply with IFRSs and meet the regulatory disclosure requirements). For example, it may be acceptable to disclose "interest income for distribution purposes" along with a very explicit description of what this amount represents, to avoid confusion that the amount is effective interest. Group members noted that the industry is working towards identifying an appropriate way to meet the regulatory requirements by presentation descriptions and alternatives. Some financial statement preparers face limitations with the systems and data available and may not currently be able to provide both effective interest rate and fair value information, even if one type of information were provided as supplementary disclosure.

The Group did not recommend any further action be taken regarding this issue.

Issue 4: The Investment Entity Exemption

IFRS 12 requires an entity to disclose certain information about investments in subsidiaries, joint ventures, associates and unconsolidated structured entities, including summarized financial information and other information about the nature of, and risks associated with, such investments.

Paragraph 21A of IFRS 12 provides an exemption for investment entities as defined in IFRS 10 from providing summarized financial information about investments in associates and joint ventures that are measured at fair value. Similarly, paragraph 25A of IFRS 12 provides an exemption from some of the disclosures required in paragraph 24 about unconsolidated structured entities that it controls.

The Group considered whether an investment fund without any controlled subsidiaries is required to provide the summarized financial information required by paragraphs 21(b)-(c) of IFRS 12. Specifically, can an investment fund without any subsidiaries qualify as an investment entity for the purpose of applying the disclosure exemption in paragraph 21A of IFRS 12?

View 4A – Yes, the disclosure exemption applies.

An investment fund qualifies for the disclosure exemption in IFRS 12 if it meets the definition of investment entity in IFRS 10, regardless of whether it has any controlled subsidiaries.

View 4B – No, the disclosures are required.

An investment fund without any subsidiaries does not qualify for the disclosure exemption because an entity only applies IFRS 10 to the extent that it has one or more controlled subsidiaries.

The Group's Discussion

Group members supported View 4A that an investment fund that meets the definition of an investment entity qualifies for the disclosure exemption. Group members noted that the definition of an investment entity in IFRS 10 does not require the entity to have controlled investments. The disclosure exemption in paragraph 21A of IFRS 12 applies to any investment entity and not just to a parent that is an investment entity.

The Group did not recommend any further action be taken regarding this issue.

Issue 5: Unconsolidated Structured Entities and Funds of Funds

Some investment funds in Canada have a strategy of investing in other investment funds, referred to as "funds of funds".

A structured entity is defined in paragraph B21 of IFRS 12 as follows:

> "An entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements."

Investment funds do not need to provide the disclosures in paragraphs 24-31 of IFRS 12 for investments in unconsolidated structured entities that are controlled if the disclosures in paragraphs 19A-G of IFRS 12 are provided. However, these disclosures are required for any investments that are not controlled and are determined to be structured entities.

The Group considered whether, for practical purposes, investment funds can provide the structured entity disclosures for all underlying funds (*View 5A*), rather than determining which individual underlying funds are structured entities (*View 5B*).

The Group's Discussion

Group members supported View 5A that the investment funds may provide the structured entity disclosures for all underlying funds. Group members noted that View 5B represents the minimum disclosures required and that disclosing this information for all underlying funds (View A) is not precluded. Group members noted that as a practical expedient, funds of funds may provide the structured entity disclosures for all underlying funds, rather than assessing each interest individually to determine whether such disclosures are required. However, Group members observed that an approach falling between providing the disclosures for structured entities only (View B) and all underlying funds (View A) would not be appropriate.

The Group did not recommend any further action be taken regarding this issue.