IFRS

STAFF PAPER

June 2018

IFRS Interpretations Committee Meeting

Project	**Deferred tax – tax base of assets and liabilities**		
Paper topic	Item for continuing consideration		
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Introduction

1. At its meeting in March 2018, the IFRS Interpretations Committee (Committee) discussed a submission about the recognition of deferred tax when a lessee (entity) recognises an asset and liability at the commencement date of a lease applying IFRS 16 *Leases*. A similar question arises when an entity recognises a liability and includes in the cost of an item of property, plant and equipment the costs of decommissioning that asset. The submitter described a fact pattern in which the lease payments and decommissioning costs are deductible for tax purposes when paid.

2. The Committee decided to research developing an Interpretation aimed at addressing the question.

3. The objective of this paper is to:

   (a) present further analysis on the matter; and

   (b) explore possible standard-setting options.

Structure of the paper

4. This paper includes:

    (a) summary of staff recommendations;

    (b) background information;

    (c) staff analysis; and

    (d) staff recommendation.

5. There is one appendix to the paper:

    (a) Appendix A – Extract from March 2018 staff paper (Agenda paper 4)

Summary of staff recommendations

6. Based on the analysis presented in this paper, we recommend:

    (a) developing a narrow-scope amendment to IAS 12. That narrow-scope amendment would propose that the initial recognition exemption in paragraphs 15 and 24 of IAS 12 does not apply to transactions that give rise to both deductible and taxable temporary differences to the extent that an entity recognises a deferred tax asset and deferred tax liability of the same amount in respect of those temporary differences.

    (b) not proposing application guidance on the determination of the tax base of assets and liabilities.

Background information

Summary of previous analysis and conclusions

7. As explained in Agenda paper 4 for the March 2018 Committee meeting (previous staff paper), the submitter asked about the recognition of deferred tax in relation to leases and decommissioning costs.

8. Applying IFRS 16, at lease commencement a lessee recognises a right-of-use asset and lease liability for all leases (except short-term leases and leases of low value assets that it accounts for applying paragraph 6 of IFRS 16). A lessee measures:

   (a) the lease liability at the present value of the lease payments that are not paid at that date; and

   (b) the right-of-use asset at the amount of the liability, adjusted for advance lease payments, initial direct costs and decommissioning costs.

9. The submission described a fact pattern in which the lease payments are deductible for tax purposes on a cash basis. Throughout this paper, we refer to the assets and liabilities a lessee recognises applying IFRS 16 as lease assets and lease liabilities.

10. Applying IAS 37 and IAS 16, an entity recognises a decommissioning liability and includes in the cost of an item of property, plant and equipment the costs of decommissioning the asset[1]. The amount recognised as a liability (and included in the cost of the asset) is the best estimate of the expenditure required to settle the decommissioning obligation. Similar to the leases example, the submission describes a fact pattern in which the decommissioning costs are deductible for tax purposes on a cash basis.

11. The previous staff paper, and this paper, analyses the applicable requirements in IAS 12 using leases as an example, but the analysis applies equally to decommissioning assets and liabilities.

12. The submitter assumed that the recognition of a lease asset and lease liability at lease commencement gives rise to a taxable temporary difference in relation to the asset and a deductible temporary difference in relation to the liability. The submitter then asked whether the initial recognition exemption in paragraphs 15 and 24 of IAS 12 (referred to as the 'exemption' throughout this paper) would apply to those temporary differences. The submitter identified three different approaches in practice, which are:

[1] This is also the case for decommissioning costs associated with a right-of-use asset applying IFRS 16.

(a) *Approach 1 – the initial recognition exemption applies*

An entity applies the initial recognition exemption separately to the lease asset and lease liability.

(b) *Approach 2 – the initial recognition exemption does not apply; the lease asset and lease liability are 'integrally linked'*

An entity assesses the lease asset and lease liability together on a net basis. Thus, assuming an entity has not made lease payments before lease commencement, temporary differences do not arise on initial recognition.

(c) *Approach 3 – the initial recognition exemption does not apply to the gross temporary differences*

The initial recognition exemption is assumed to apply only when an entity recognises an asset *or* liability. Thus, the initial recognition exemption does not apply on initial recognition of the lease asset and lease liability because an entity recognises an asset *and* liability at the same time.

13. The outreach performed indicated that the matter is widespread and that entities apply different reporting methods, both within and across jurisdictions. One outreach response also noted the application of different reporting methods to leases and to decommissioning costs in the same jurisdiction. For further details of the outreach performed, please refer to paragraphs 13–20 of the previous staff paper.

14. Our analysis refuted the assumption that, in all cases, temporary differences arise on initial recognition of lease assets and lease liabilities. We clarified that, in our view, as a first step an entity needs to determine *whether* temporary differences arise on initial recognition of a lease asset and lease liability. To do so, an entity determines the tax base of the asset and liability by considering the applicable tax law. In other words, the entity considers the applicable tax law in determining whether to attribute the tax deductions to the lease asset or lease liability.

15. We also noted that, in our view, determining the attribution of the tax deductions to the lease asset or lease liability is not an accounting policy choice. An entity applies judgement having considered and analysed the applicable tax law, and we would

expect entities in the same jurisdiction to apply the same judgement for similar transactions.

16. The analysis further illustrated that:

    (a) if an entity attributes the tax deductions to the lease asset, temporary difference do not arise at lease commencement and, thus, the initial recognition exemption is not applicable.

    (b) if an entity attributes the tax deductions to the lease liability, a temporary difference arises in respect of both the asset and the liability. The initial recognition exemption applies to those temporary differences and an entity would not recognise deferred tax.

Summary of discussions at the March 2018 Committee meeting

17. Committee members agreed that, applying IAS 12, an entity first determines the tax base of the lease asset and lease liability and assesses whether temporary differences arise on initial recognition.

18. Many Committee members also agreed that entities attribute the tax deductions to either the lease asset or lease liability. However, members noted that IAS 12 does not contain any requirements on how an entity would make that assessment. In particular, some members said the view expressed by the staff in paragraphs 27 and 28 of the previous staff paper (reproduced in Appendix A to this paper) could not be derived as a requirement from the words in IAS 12. These members said the staff view was only one possible way of interpreting the existing requirements in IAS 12.

19. Some Committee members said the diversity in reporting methods results from different interpretations of the requirements in IAS 12. In their view, resolving the matter would require standard setting. Members suggested that any standard setting should be narrow in scope and not open up a wider debate on the requirements in IAS 12. They noted that in 2016 the Board had already considered whether to add a project on IAS 12 to its work plan, and had decided not to do so.

20. Some Committee members also raised questions about the subsequent accounting that could result from applying the different approaches identified in the submission—our analysis in this paper discusses subsequent accounting.

21. Based on these discussions, the Committee decided to research developing an Interpretation aimed at addressing the question.

Staff analysis

22. Since the March 2018 meeting, we have conducted further research in exploring the standard-setting options that the Committee might undertake, or recommend, to address the matter.

23. This section of the paper:

    (a) considers the requirements on the recognition of deferred tax in IAS 12, and how applying those requirements gives rise to the question the Committee aims to address (see paragraphs 24–45); and

    (b) explores two standard-setting options the Committee might undertake to address the question (see paragraphs 46–71).

The requirements to recognise deferred tax in IAS 12

The principle in IAS 12 regarding deferred tax

24. Paragraph 10 of IAS 12 refers to the fundamental principle in IAS 12 regarding the recognition of deferred tax as follows:

> …the fundamental principle upon which the Standard is based: that an entity shall, with certain limited exceptions, recognise a deferred tax liability (asset) whenever recovery or settlement of the carrying amount of an asset or liability would make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences.

25. The application of this principle is illustrated in the example included in paragraph 16 of IAS 12, reproduced below:

> An asset which cost 150 has a carrying amount of 100. Cumulative depreciation for tax purposes is 90 and the tax rate is 25%.
>
> *The tax base of the asset is 60 (cost of 150 less cumulative tax depreciation of 90). To recover the carrying amount of 100, the entity must earn taxable income of 100, but will only be able to deduct tax depreciation of 60. Consequently, the entity will pay income taxes of 10 (40 at 25%) when it recovers the carrying amount of the asset. The difference between the carrying amount of 100 and the tax base of 60 is a taxable temporary difference of 40. Therefore, the entity recognises a deferred tax liability of 10 (40 at 25%) representing the income taxes that it will pay when it recovers the carrying amount of the asset.*

26. This example illustrates how the fundamental principle in IAS 12 is reflected in the requirements to recognise a deferred tax liability related to the tax consequences of the future recovery of the associated asset. In this example, the recognition of deferred tax also affects profit or loss in line with the recovery of the asset, resulting in an effective tax rate that is consistent with the applicable tax rate.

27. To illustrate, we have used the example in paragraph 25 of this paper, and assumed that the entity has taxable income of CU100[2] in the reporting period in which it acquired the asset. For simplicity, we have also assumed that the entity recognises a depreciation charge of CU50 and a tax depreciation of CU90 in that period. The entity therefore:

    (a) acquires the asset for CU150 and recognises a depreciation charge of CU50 in the period;

    (b) generates income of CU100 and deducts depreciation on the asset of CU90 for tax purposes, recognising a current tax expense of CU2.5 (CU10 at 25%); and

    (c) recognises deferred tax expense and a deferred tax liability of CU10 (as explained in paragraph 25 of this paper).

[2] CU = currency unit.

28. The following table shows the effects in profit or loss of recognising (or not recognising) deferred tax for the period. It demonstrates that, if the entity does not recognise deferred tax, the tax expense reflects the deductions available for tax purposes in the period, instead of reflecting the tax effects of recovering the asset in the period.

	Deferred tax **is** recognised CU	Deferred tax is **not** recognised CU
Revenue	100	100
Depreciation expense	(50)	(50)
Profit before tax	*50*	*50*
Current tax expense	2.5	2.5
Deferred tax expense/(income)	10	-
Tax expense	*12.5*	*2.5*
Profit after tax	*37.5*	*47.5*
Effective tax rate (Tax expense / Profit before tax)	25.0%	5.0%

Recognition requirements and the initial recognition exemption

29. The fundamental principle discussed above in paragraphs 24–28 is reflected in the requirements for the recognition of deferred tax assets and liabilities in paragraphs 15 and 24 of IAS 12, which state:

> 15. A deferred tax liability shall be recognised for all taxable temporary differences, except to the extent that the deferred tax liability arises from:
>
> (a) the initial recognition of goodwill; or
>
> (b) the initial recognition of an asset or liability in a transaction which:
>
> (i) is not a business combination; and
>
> (ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).
>
> ….

> 24. A deferred tax asset shall be recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised, unless the deferred tax asset arises from the initial recognition of an asset or liability in a transaction that:
>
> (a) is not a business combination; and
>
> (b) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

30. We note that, consistent with the fundamental principle, these paragraphs require entities to recognise deferred tax for *all* temporary differences, with some limited exceptions. However, as one of these exceptions, paragraphs 15 and 24 of IAS 12 *prohibit* an entity from recognising deferred tax assets and deferred tax liabilities for temporary differences arising from the initial recognition of an asset or liability in a transaction that is not a business combination, and at the time of the transaction affects neither accounting profit nor taxable profit (tax loss). We consider the purpose of this exemption below in paragraph 48 of this paper.

Applying the requirements to the situation described in the submission

31. The previous staff paper discussed how an entity determines whether temporary differences arise on initial recognition of a lease asset and lease liability. It also presented our view that the initial recognition exemption applies when such temporary differences arise.

32. To further understand the matter raised by the submitter, we have analysed the effects of applying the initial recognition exemption to the subsequent accounting of income taxes in the situation described in the submission. To do so, we used the same example discussed in the previous staff paper, and illustrated the subsequent accounting in the following scenarios:

    (a) tax deductions are attributable to the lease asset (and future interest accrual); and

(b) tax deductions are attributable to the lease liability (and future interest accrual).

33. The example is one in which a lessee (Lessee) rents a building for five years. The lease payments are CU100 per year, payable at the end of each year. Lessee's incremental borrowing rate is 5%. Lessee calculates the present value of the lease payments on initial recognition of the lease asset and lease liability as CU435. The lease payments are deductible for tax purposes on a cash basis.

Tax deductions are attributable to the lease asset

34. Paragraphs 32–42 of the previous staff paper (see Appendix A to this paper) discuss the application of the requirements in IAS 12 when the tax deductions from the lease are attributable to the lease asset. Those paragraphs illustrate that in this scenario temporary differences do not arise on initial recognition, and therefore the initial recognition exemption does not apply. They also illustrate that deductible temporary differences arise after initial recognition, as an entity depreciates the lease asset and repays the lease liability.

35. Expanding the analysis described above in paragraph 34 of this paper, we observe that paragraph 24 of IAS 12 applies to these deductible temporary differences when they arise after initial recognition. Therefore, an entity recognises a deferred tax asset and deferred tax income as the temporary differences arise.

36. The effect of recognising deferred tax income—and, later, a deferred tax expense when the temporary differences unwind—is that of recognising the tax benefit of the transaction, which arise in the form of tax deductions, in line with the pattern of recovery of the asset through depreciation and with the accrual of interest over the lease liability.

37. To illustrate, we have reproduced the table in paragraph 36 of the previous staff paper, and supplemented it by showing the current and deferred tax expense. The example assumes the entity recognises revenue of CU120 in each of the periods and is subject to a tax rate of 20%.

	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Depreciation	87	87	87	87	87
Interest expense	22	17	13	9	4
Total in P&L	**109**	**104**	**100**	**96**	**91**
Tax deduction	100	100	100	100	100
Temporary difference	9	4	-	(4)	(9)
Deferred tax income / (expense) (@20%)	**1.8**	**0.8**	**-**	**(0.8)**	**(1.8)**
Carrying amount of deferred tax asset recognised at the end of the year	**1.8**	**2.6**	**2.6**	**1.8**	**-**
Revenue	120	120	120	120	120
Tax deduction	(100)	(100)	(100)	(100)	(100)
Taxable profit	20	20	20	20	20
Current tax expense (@20%)	**4**	**4**	**4**	**4**	**4**

38. The following table illustrates the entity's statement of profit or loss during the 5-year lease term. The table shows that recognising and unwinding deferred tax results in the entity allocating the tax effects of the transaction in line with how the recovery of the lease asset and settlement of the lease liability affect profit or loss (ie depreciation and interest relating to the lease).

	Year 1	Year 2	Year 3	Year 4	Year 5
Revenue	120	120	120	120	120
Depreciation expense	(87)	(87)	(87)	(87)	(87)
Interest expense	(22)	(17)	(13)	(9)	(4)
Profit before tax	*11*	*16*	*20*	*24*	*29*
Current tax expense	4	4	4	4	4
Deferred tax expense/(income)	(1.8)	(0.8)	-	0.8	1.8
Tax expense	*2.2*	*3.2*	*4.0*	*4.8*	*5.8*
Profit after tax	*8.8*	*12.8*	*16.0*	*19.2*	*23.2*
Effective tax rate (Tax expense / Profit before tax)	20%	20%	20%	20%	20%

Tax deductions are attributable to the lease liability

39. The fact pattern is the same as the one discussed in the previous example. However, in this scenario the tax deductions are attributable to the lease liability, instead of to the lease asset. For the reasons discussed in paragraphs 44–48 of the previous staff paper (see Appendix A to this paper), our view is that in this scenario (a) temporary differences arise on initial recognition of the lease asset and lease liability, (b) the initial recognition exemption applies, and thus (c) the entity does not recognise deferred tax.

40. If the transaction is not a business combination and affects neither accounting profit nor taxable profit, paragraph 22(c) of IAS 12 does not permit an entity to recognise the deferred tax liability or asset, either on initial recognition or subsequently. It therefore follows that an entity does not recognise deferred tax as it depreciates the lease asset or settles the lease liability.

41. The table below shows the temporary differences arising on initial recognition and over the 5-year lease term on both the lease asset and lease liability, for which no deferred tax is recognised. It also shows that the net unrecognised deferred tax asset is equal, in each period, to the deferred tax asset recognised in the previous scenario, as illustrated in paragraph 37 of this paper.

	Lease asset		
	Carrying amount	**Tax base**	**Taxable temporary difference**
Initial recognition	435	-	435
Year 1	348	-	348
Year 2	261	-	261
Year 3	174	-	174
Year 4	87	-	87
Year 5	-	-	-

	Lease liability		
	Carrying amount	**Tax base**	**Deductible temporary difference**
Initial recognition	435	-	435
Year 1	357	-	357
Year 2	274	-	274
Year 3	187	-	187
Year 4	96	-	96
Year 5	-	-	-

	Net unrecognised deferred tax asset[3]
Initial recognition	-
Year 1	1.8
Year 2	2.6
Year 3	2.6
Year 4	1.8
Year 5	-

42. Because the entity did not recognise deferred tax assets or liabilities, it also does not recognise any deferred tax expense or income over the 5-year lease term. Consequently, the income tax expense comprises only current tax, which reflects the tax deductions in the periods in which they are available for tax purposes.

[3] The net unrecognised deferred tax asset is calculated as the deductible temporary difference on the lease liability less the taxable temporary difference on the lease asset, multiplied by the applicable tax rate. For example, the net unrecognised deferred tax asset at the end of Year 1 of CU1.8 is calculated as: ((CU357 – CU348)*20%).

	Year 1	Year 2	Year 3	Year 4	Year 5
Income statement					
Revenue	120	120	120	120	120
Depreciation expense	(87)	(87)	(87)	(87)	(87)
Interest expense	(22)	(17)	(13)	(9)	(4)
Profit before tax	*11*	*16*	*20*	*24*	*29*
Current tax expense	*4*	*4*	*4*	*4*	*4*
Deferred tax expense/(income)	-	-	-	-	-
Tax expense	*4*	*4*	*4*	*4*	*4*
Profit after tax	*7*	*12*	*16*	*20*	*25*
Effective tax rate (Tax expense / Profit before tax)	36%	25%	20%	17%	14%

43. If the initial recognition exemption had not applied, we note that the subsequent unwinding of the temporary differences (and corresponding adjustments to the carrying amounts of the deferred tax asset and liability) would have the same results as those illustrated in paragraph 37 of this paper (ie it would have resulted in aligning the tax expense with the profit or loss from accounting for the lease). This is because the same net temporary difference would have existed throughout the lease term.

The issue arising from the application of the exemption

44. We observe that the application of the exemption in IAS 12 affects the subsequent accounting of the tax effects of the transaction. In particular, it can cause differences in outcomes depending on whether an entity attributes the future tax deductions to the lease asset or lease liability, even though the net temporary difference arising from the transaction is the same in either case.

45. As illustrated in paragraphs 39–42 of this paper, applying the exemption to a lease transaction might result in the entity reflecting the tax effects of the transaction in profit or loss as the tax deductions become available for tax purposes, and not when the recovery (or settlement) of the associated lease asset and lease liability is reflected in profit or loss.

Possible standard-setting options

46. Considering the findings from our analysis in this paper, we have identified the following standard-setting options that could address the issue:

    (a) *Option 1:* Narrow the scope of the initial recognition exemption so that it does not apply to transactions that give rise to both deductible and taxable temporary differences to the extent that an entity recognises a deferred tax asset and liability of the same amount. This could be achieved by proposing a narrow-scope amendment to IAS 12. We discuss this option in paragraphs 47–61 of this paper.

    (b) *Option 2:* Interpret the requirements in IAS 12 in a way that is consistent with the logic presented in the previous staff paper. This could be achieved by developing an Interpretation of IAS 12. We discuss this option in paragraphs 62–66 of this paper.

Option 1: Propose an amendment to narrow the scope of the initial recognition exemption

What is the purpose of the exemption?

47. Paragraph 22(c) of IAS 12 provides the basis for the initial recognition exemption, as follows:

> … if the transaction is not a business combination, and affects neither accounting profit nor taxable profit, an entity would, in the absence of the exemption provided by paragraphs 15 and 24, recognise the resulting deferred tax liability or asset and adjust the carrying amount of the asset or liability by the same amount. Such adjustments would make the financial statements less transparent. Therefore, this Standard does not permit an entity to recognise the resulting deferred tax liability or asset, either on initial recognition or subsequently. Furthermore, an entity does not recognise subsequent changes in the unrecognised deferred tax liability or asset as the asset is depreciated.

48. This paragraph clarifies that the purpose of the exemption is to avoid the adjustment to the carrying amount of an asset or liability that would be necessary if an entity were to recognise a deferred tax asset or liability. That adjustment would make the financial statements less transparent. It would also be inappropriate to recognise it as a gain or loss in profit or loss, given that the transaction itself has no effect on profit or loss.

Is the exemption necessary in the situation described in the submission?

49. The submission described a fact pattern in which lease payments are deductible for tax purposes on a cash basis. Applying IAS 12, an entity attributes these tax deductions to the lease asset or lease liability to determine their respective tax bases on initial recognition.

50. We note that, regardless of how an entity attributes the tax deductions, temporary differences associated with the lease asset and lease liability would, on initial recognition, either:

    (a) not arise—for example, if the tax deductions are attributed to the lease asset; or

    (b) be of equal and offsetting amounts (ie taxable and deductible temporary differences of the same amount arise)—for example, if the tax deductions are attributed to the lease liability.

    This is because the carrying amount of the lease asset and lease liability are the same on initial recognition[4] and, because the attribution of tax deductions determines their tax bases, any reduction (or increase) in the tax base of the lease asset results in an increase (or reduction) in the tax base of the lease liability by the same amount. Hence, there is no effect on the 'net' temporary difference, which is always nil on initial recognition.

51. In the situation described in paragraph 50(a) above, the exemption would not apply because temporary differences do not arise on initial recognition of the lease asset and lease liability.

[4] For the purpose of this analysis, we will assume the entity makes no advance lease payments or incurs initial direct costs on or before lease commencement. Paragraph 55 considers situations in which the carrying amounts of the lease asset and lease liability are not the same on initial recognition.

52. In all other cases, taxable and deductible temporary differences arise on initial recognition at the same amount in respect of the lease asset and lease liability. In these cases, we note that, if the exemption were not applied, an entity would have recognised a deferred tax asset and liability of the same amount.[5]

53. This means the undesirable outcome the exemption was designed to prevent (see paragraph 47 above) does not exist for a lease transaction. This is because the simultaneous recognition of a deferred tax asset and liability of the same amount would result in no net effect on the tax recognised in profit or loss, nor does it require adjustment to the carrying amount of the related lease asset or lease liability. Therefore in our view the exemption is not necessary for a lease transaction. Furthermore, not applying the exemption would avoid the outcomes discussed in paragraphs 44 and 45 of this paper.

Consideration of more complex situations

54. In paragraphs 49-53 above, we conclude that the exemption is not necessary for a transaction that creates equal taxable and deductible temporary differences. However, there might be some situations for which equal taxable and deductible temporary differences do not result in the recognition of equal amounts of deferred tax assets and liabilities. This would be the case, for example, if an entity is unable to recognise a deferred tax asset related to deductible temporary differences because it is not probable that taxable profit will be available against which the temporary differences can be utilised. In these situations, we think the exemption is not necessary *only to the extent* an entity would recognise a deferred tax asset and liability of the same amount.

55. There might also be some situations in which the carrying amounts of the lease asset and lease liability are not the same on initial recognition. For example, when an entity makes advance lease payments on or before lease commencement. Applying the same assumption that lease payments (including advance payments) are deductible for tax purposes on a cash basis, an entity recognises deferred tax when it makes the advance payments because the payments affect taxable profit. Therefore, the analysis described in paragraph 50 of this paper would still apply to the initial recognition of the lease

[5] Assuming it is probable that taxable profit will be available against which the deductible temporary difference can be utilised. Paragraph 54 considers situations in which this is not the case.

liability and the respective component of the cost of the lease asset, neither of which affect accounting profit or taxable profit on initial recognition.

Proposed solution

56. In the light of the above analysis, we think narrowing the application of the initial recognition exemption to exclude situations for which it is not necessary would improve IAS 12, and provide an appropriate accounting outcome for transactions such as leases and decommissioning costs.

57. For such transactions, narrowing the exemption would result in allocating the tax benefits of the transaction in a manner that aligns with how the recovery of the asset and settlement of the liability affect profit or loss. This is consistent with the fundamental principle in IAS 12—see paragraph 24 of this paper—and would also lead to an effective tax rate that is consistent with the applicable tax rate for the transaction.

58. Narrowing the application of the exemption would lead to an accounting outcome that is similar to those described in approach 2 and approach 3 of the original submission. We think such approaches may have developed in practice, in part, to avoid what might be viewed as an imperfect outcome of applying the exemption (as discussed in paragraph 45 of this paper).

59. The proposed change would result in entities recognising deferred tax assets and liabilities on a gross basis when temporary differences arise at initial recognition. However, we think the application of paragraphs 74–75 of IAS 12—ie the requirement to offset deferred tax assets and liabilities in specified circumstances—would typically result in the entity offsetting such items on the balance sheet. Entities would nonetheless be required to disclose separately the amount of deferred tax in respect of temporary differences arising from the lease asset and lease liability to comply with the disclosure requirements in paragraph 81(g) of IAS 12.

Previous discussions regarding the exemption in IAS 12

60. The Committee recently discussed another matter involving the application of the exemption when an entity acquires a single-asset entity that is not a business. The agenda decision published in *IFRIC Update* in March 2017 states:

> The Committee also concluded that any reconsideration of the initial recognition exception in paragraph 15(b) of IAS 12 is something that would require a Board-level project. Consequently, the Committee decided not to add this issue to its agenda.
>
> The Committee noted that the Board had recently considered whether to add a project on IAS 12 to the Board's agenda, but had decided not to do so. Consequently, the Committee did not recommend that the Board consider adding a project to its agenda on this topic.

61. We think the consideration of the exemption in this paper is different from its consideration in the case of the acquisition of a single-asset entity that is not a business. This is because the scope of any proposed amendment discussed in this paper would be solely to narrow the application of the exemption in situations in which it is not necessary—it would not involve a more comprehensive review of its merits and application, which in our view would be needed in the context of the request regarding the acquisition of a single-asset entity.

Option 2: Develop an Interpretation

Determining the tax base of assets and liabilities

62. In the fact pattern described in the submission, applying IAS 12 an entity first determines the tax base of the asset and liability by considering the applicable tax law. In our view, an entity does this by attributing the future tax deductions arising from the transaction to either the asset or liability. Consequently, temporary differences may, or may not, arise on initial recognition of the asset and liability, depending on the attribution of the future tax deductions. We agree with Committee members who noted at the March 2018 meeting that IAS 12 does not include requirements explaining how an entity might attribute future tax deductions in a transaction that gives rise to the recognition of an asset and liability.

63. Paragraphs 22–26 of the previous staff paper (see Appendix A to this paper) explain our view regarding the determination of the tax base applying IAS 12.

Applying the exemption to separate assets and liabilities

64. For the reasons discussed in paragraphs 44–48 of the previous staff paper (see Appendix A to this paper), we think the exemption applies separately to the lease asset and lease liability. Notwithstanding this view, the different reporting methods identified in the submission and the results of outreach indicate that, in practice, entities interpret the requirements of IAS 12 differently when applying them to temporary differences associated with leases and decommissioning costs.

65. Therefore, in order to address the diversity in reporting methods identified, the Committee could develop an Interpretation to clarify how an entity interprets the requirements in IAS 12 when a transaction results in the recognition of an asset and liability. In our view, the Interpretation could:

    (a) clarify that:

        (i) as a first step, IAS 12 requires entities to determine the tax base of the asset and liability. This is done by attributing the future tax deductions arising from the transaction to either the asset or liability, considering the applicable tax law; and

        (ii) the initial recognition exemption applies separately to any deferred tax asset and liability that arises from initial recognition of the related asset and liability.

    (b) provide application guidance to help entities in determining how to attribute future tax deductions to the asset or liability in situations in which it is not clear from the applicable tax law how to attribute those deductions.

66. In providing application guidance on the attribution of future tax deductions, the Committee could consider the views expressed in paragraphs 27 and 28 of the previous staff paper (see Appendix A to this paper). For example, in jurisdictions for which an entity more frequently receives tax deductions for the use of an asset (ie depreciation) and for interest payments on a loan—rather than for repayments of the principal amount of borrowings—the entity would attribute the tax deductions for lease payments to the lease asset. Applying such application guidance, we think an entity might often attribute the tax deductions to the lease asset (rather than the lease liability), and thus temporary differences would not arise on initial recognition. In that

case, the exemption would not apply—this would result in the entity recognising deferred tax after initial recognition.

Assessment of the options and conclusion

67. We assessed the two options discussed in this paper, namely:

    (a) proposing a narrow-scope amendment to IAS 12 as described in paragraphs 47–61 of this paper (hereafter referred to as 'Amendment'); and

    (b) developing an Interpretation as described in paragraphs 62–67 of this paper (hereafter referred to as 'Interpretation').

68. In our view, proposing the Amendment would be the most effective way to resolve the issue identified. This is because the Amendment:

    (a) would eliminate existing diversity in how entities recognise deferred tax in relation to leases and decommissioning costs when lease payments and decommissioning costs are deductible for tax purposes on a cash basis. This is because, if the Amendment were made, the accounting that would result from attributing the future tax deductions to the lease asset would be very similar to the accounting that would result from attributing those deductions to the lease liability. In contrast, applying the requirements that would be provided in the Interpretation, entities that attribute future tax deductions to the lease liability would have different outcomes to those that attribute those deductions to the lease asset, even though the net temporary difference arising from the transaction is the same in either case (as paragraphs 34–43 of this paper explain).

    (b) would improve the subsequent accounting for the tax effects of the transaction by aligning the tax effects of the transaction with how the recovery of the asset and the settlement of the liability affect profit or loss.

    (c) would be narrow in scope. The Amendment would be limited to narrowing the applicability of an exemption already in IAS 12, thereby avoiding the risks of unintended consequences that could arise from more substantial

changes to the Standard. It would also be consistent with the existing principle in IAS 12, not a departure from it.

(d) would potentially be easier to apply and understand than a new Interpretation. The Interpretation would still require an entity to apply judgement in determining, for each tax jurisdiction in which it has leases or decommissioning costs, whether to attribute tax deductions to the lease asset or lease liability. There is a risk that entities might reach different conclusions within the same jurisdiction.

Proposing an amendment that incorporates both options

69. The Amendment described above would be limited to narrowing the applicability of the exemption in the situations discussed in this paper; it would not propose to change any other aspect of IAS 12. Accordingly, IAS 12 would still require entities to determine the tax base of the asset and liability recognised, and to disclose separately deferred tax in respect of each type of temporary difference. It might therefore be helpful to provide application guidance on how an entity determines the tax base of the asset and liability in the situations discussed in this paper in addition to narrowing the applicability of the exemption.

70. Although potentially helpful in some respects, we think such application guidance would add complexity to any standard-setting undertaken and is not required to resolve the issue identified. This is because, if the Amendment were made, there would be little difference in the accounting that would result, regardless of how an entity attributes the future tax deductions and thus determines the tax base of the asset and liability. Consequently, we think adding such application guidance would add limited incremental benefit.

71. On balance, our view is that the Committee should not propose further application guidance on determining the tax base of assets and liabilities.

Staff recommendation

72. Based on our analysis, we recommend:

    (a) developing a narrow-scope amendment to IAS 12. That narrow-scope amendment would propose that the initial recognition exemption does not apply to transactions that give rise to both deductible and taxable temporary differences to the extent that an entity recognises a deferred tax asset and deferred tax liability of the same amount in respect of those temporary differences; and

    (b) not proposing application guidance on the determination of the tax base of assets and liabilities.

Question for the Committee
Does the Committee agree with our recommendation in paragraph 72 of this paper? If not, what would the Committee recommend? Please explain why.

Appendix A – Extract from the March 2018 staff paper (Agenda paper 4)

A1. For ease of reference, we have reproduced below the staff analysis section of the previous staff paper.

Staff analysis

21. As mentioned in paragraph 11 the submission assumes temporary differences arise on initial recognition of lease assets and lease liabilities, and asks whether the initial recognition exemption applies. We do not agree with this assumption. In our view, as a first step an entity needs to determine *whether* there is a temporary difference on initial recognition of a lease asset and lease liability.

Tax base of lease asset and lease liability

22. Paragraph 5 of IAS 12 defines temporary differences as 'differences between the carrying amount of an asset or liability in the statement of financial position and its tax base'.

23. Paragraph 5 of IAS 12 also defines the tax base of an asset or liability as 'the amount attributed to that asset or liability for tax purposes'. Paragraphs 7 and 8 of IAS 12 state:

> The tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset. If those economic benefits will not be taxable, the tax base of the asset is equal to its carrying amount.
>
> The tax base of a liability is its carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods.

24. Accordingly, to determine whether temporary differences arise on initial recognition of the lease asset and lease liability, an entity needs to determine the

tax base of that asset and liability. To do so, the entity considers the applicable tax law to determine the amount attributable to the lease asset and lease liability for tax purposes. In other words, the entity considers the applicable tax law to assess what the tax deductions relate to.

25. In our view, depending on the provisions of the applicable tax law, the entity might determine that the tax deductions are attributable to either:

    (a) the lease asset, because the deductions relate to the expenses arising from the lease, ie for IFRS reporting purposes depreciation and interest expense, discussed in paragraphs 31–42 of this paper; or

    (b) the repayment of the lease liability, discussed in paragraph 43 of this paper.

26. In the fact pattern in the submission, tax deductions are available for the payments made under the lease contract. This does not necessarily mean that the tax authority regards the deductions as relating to the repayment of a liability (as assumed in the submission). The tax authority is simply giving tax deductions for specified cash outflows. The entity recognises those cash outflows in profit or loss over the lease term as depreciation and interest expense. It is a matter of judgement, having considered the applicable tax law, as to whether the entity regards the tax deductions as relating to:

    (a) depreciation (and thus partly attributed to the lease asset) and interest expense, or

    (b) the repayment of the principal amount of the lease liability (and thus partly attributed to the lease liability) and interest expense.

27. The accounting for leases in IFRS 16 is similar to the accounting for the financed purchase of an asset (for example, when the entity obtains a loan to purchase an item of property, plant and equipment). In many jurisdictions, repayments of the principal amount of borrowings are not deductible for tax purposes. An entity more frequently receives tax deductions for the use of an asset (ie depreciation) and for interest payments on a loan. In these circumstances, we would expect the entity to attribute the tax deductions it

claims for lease payments to the lease asset (for deductions relating to depreciation) and to the future interest accrual (for deductions relating to the future interest expense).

28. In contrast, in jurisdictions for which repayments of the principal amount of borrowings are deductible for tax purposes, we would expect the entity to attribute the tax deductions to the repayment of the lease liability (for deductions relating to the repayment of the principal) and to the future interest accrual (for deductions relating to the future interest expense).

29. In our view, determining the attribution of the tax deductions to the lease asset or lease liability as described in paragraph 25 of this paper is not an accounting policy choice. An entity applies judgement having considered and analysed the applicable tax laws. We would expect entities in the same tax jurisdiction to apply the same judgement for similar transactions.

30. An entity would disclose the judgement made applying paragraph 122 of IAS 1 *Presentation of Financial Statements* if that judgement is part of the entity's judgements made in applying its accounting policies that have the most significant effect on the amounts recognised in the financial statements.

Tax deductions are attributable to the lease asset

31. When an entity attributes the tax deductions to the lease asset and future interest accrual, at lease commencement the tax base of the asset equals its carrying amount[6] applying paragraph 7 of IAS 12 (reproduced in paragraph 23 of this paper). This is because the carrying amount will be fully deductible for tax purposes in future periods. Applying paragraph 8 of IAS 12 (also reproduced in paragraph 23), the tax base of the liability also equals its carrying amount. This is because the carrying amount will not be deductible for tax purposes in future periods. Tax deductions will be available for interest that the entity has not yet accrued at lease commencement. Accordingly, in this scenario temporary differences do not arise on initial recognition of the lease asset and lease

[6] Assuming the entity makes no lease payments before lease commencement.

liability, and thus the entity does not recognise any deferred tax at lease commencement.

32. To illustrate, we have used the example provided in the submission. Lessee rents a building for five years. The lease payments are CU100[7] per year, payable at the end of each year. Lessee's incremental borrowing rate is 5%. Lessee calculates the present value of the lease payments on initial recognition of the lease asset and lease liability as CU435. The lease payments are deductible for tax purposes on a cash basis.

33. The table below shows the carrying amount of the lease asset and lease liability over the 5-year lease term:

Lease liability, CU

	Opening carrying amount	Interest accrued	Payments	Closing carrying amount
Year 1	435	22	(100)	357
Year 2	357	17	(100)	274
Year 3	274	13	(100)	187
Year 4	187	9	(100)	96
Year 5	96	4	(100)	-
Total		**65**	**(500)**	

Lease asset, CU

	Opening carrying amount	Depreciation[8]	Closing carrying amount
Year 1	435	(87)	348
Year 2	348	(87)	261
Year 3	261	(87)	174
Year 4	174	(87)	87
Year 5	87	(87)	-
Total		**(435)**	

34. The tables above illustrate that the entity recognises total lease payments of CU500 in profit or loss over the 5-year period as depreciation of CU435 and

[7] CU = currency unit

[8] In this example, Lessee depreciates the asset on a straight-line basis over the 5-year lease term. We also assume there are no initial direct costs and no impairment of the lease asset during this period.

interest expense of CU65. The tax deductions of CU500 relate to depreciation (CU435) and interest expense (CU65) and, thus, the tax base of the lease asset equals its carrying amount (CU435) on initial recognition. Accordingly, a temporary difference does not arise on initial recognition of the lease asset.

35. Tax deductions are not available in respect of the lease liability because the entity does not accrue interest on initial recognition of the lease liability. Tax deductions will be available in each of the 5 years of the lease when the entity accrues interest on the lease liability.

36. As illustrated, if the tax deductions relate to depreciation and interest expense, on initial recognition temporary differences do not arise on the lease asset or the lease liability. In subsequent periods, temporary differences will arise because the tax deductions obtained by the entity in each reporting period on a cash basis will not equal the total expense recognised by the entity in profit or loss. The following table illustrates this.

	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Total**
Depreciation	87	87	87	87	87	435
Interest expense	22	17	13	9	4	65
Total in P&L	**109**	**104**	**100**	**96**	**91**	**500**
Tax deduction	100	100	100	100	100	500
Difference	9	4	-	-4	-9	-

37. In Year 1, the entity recognises a total expense of CU109 (comprising CU87 depreciation and CU22 interest expense) whereas the tax deduction obtained equals the cash paid (CU100). Consequently, a temporary difference of CU9 arises. There is a question as to whether this difference relates to the lease asset or lease liability. In other words, how does the entity attribute the tax deduction obtained of CU100 for the lease payment made during the period? In our view, it will depend on the applicable tax law. We think it would be appropriate to allocate the tax deduction first to interest expense and then to depreciation if, in a particular tax jurisdiction, it is more common to have a temporary difference relating to depreciation than to interest. For example, this might be the case if

the amount of interest deductible for tax purposes is typically the same as the amount accrued in profit or loss.

38. Using this approach, in Year 1 the entity would allocate a tax deduction of CU22 to interest expense, and the remainder of CU78 (CU100 – CU22) to depreciation. Because depreciation recognised in profit or loss is CU87, the carrying amount of the lease asset at the end of Year 1 will be different from its tax base. A temporary difference therefore arises on the lease asset of CU9, as illustrated in the table below.

	Carrying amount of the lease asset[3]	Tax base of the lease asset[9]	Deductible temporary difference
Year 1	348	357	(9)
Year 2	261	274	(13)
Year 3	174	187	(13)
Year 4	87	96	(9)
Year 5	-	-	-

39. Depending on the applicable tax law, it might also be appropriate to allocate the tax deduction first to depreciation and then to interest. In this case, the carrying amount of the lease asset equals its tax base because the depreciation recognised in the profit or loss is the same as depreciation for tax purposes. The temporary difference of CU9 will therefore arise on the lease liability.

40. As mentioned above, this allocation will require judgement considering the applicable tax law. Nonetheless, we note that the carrying amount of the deferred tax asset recognised is unaffected by that judgement. In the example above, the temporary difference at the end of Year 1 is CU9, regardless of how the entity allocates it. The allocation affects only the disclosures required by paragraph 81 of IAS 12.

[9]The carrying amount of the lease asset at the end of Year 1 is calculated as follows: CU435 (the carrying amount on initial recognition) – CU87 (depreciation) = CU348.

The tax base of the lease asset at the end of Year 1 is calculated as follows: CU435 (the tax base on initial recognition) – CU78 (tax deduction related to depreciation) = CU357.

41. In this scenario—ie when an entity attributes tax deductions to the lease asset and future interest accrual, we note that the initial recognition exemption in paragraphs 15 and 24 of IAS 12 is not applicable because temporary differences do not arise on initial recognition of the lease asset and lease liability. Accordingly, the unit of account considerations discussed in paragraphs 44-48 of this paper do not apply in this scenario.

42. This scenario also leads to the same outcome as that of Approach 2 and Approach 3 described in the submission, however the rationale is different. We do not support the rationale provided for Approach 2 and Approach 3 in the submission for the reasons provided in paragraphs 47 and 48 of this paper.

Tax deductions are attributable to the lease liability

43. Depending on the provisions of the applicable tax law, an entity might attribute the tax deductions to the repayment of the principal amount of the lease liability and the future interest accrual. In this case, applying paragraph 8 of IAS 12 the tax base of the liability is zero because the carrying amount of the liability will be fully deductible for tax purposes in future periods. Consequently, a temporary difference arises on initial recognition of the lease liability. Because the entity attributes no tax deductions to the lease asset, its tax base is zero. A temporary difference also therefore arises on the lease asset. Paragraphs 44–48 below analyse whether, in this scenario, an entity recognises a deferred tax asset and liability for those temporary differences, or whether the initial recognition exemption applies.

Unit of account in IAS 12—if temporary differences arise on the asset and liability at initial recognition

44. Assuming that temporary differences arise on the lease asset and lease liability at lease commencement (as in the scenario discussed in paragraph 43 above), an entity then considers whether to recognise a deferred tax asset and deferred tax liability for those temporary differences. To do so, an entity considers whether the initial recognition exemption in paragraphs 15 and 24 of the IAS 12 apply.

If the initial recognition exemption does not apply, the entity would recognise a deferred tax asset and a deferred tax liability for the temporary differences.

45. Paragraphs 15 and 24 of IAS 12 state the following:

> 15. A deferred tax liability shall be recognised for all taxable temporary differences, except to the extent that the deferred tax liability arises from:
>
> (a) the initial recognition of goodwill; or
>
> (b) the initial recognition of an asset or liability in a transaction which:
>
> (i) is not a business combination; and
>
> (ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).
>
> ….
>
> 24. A deferred tax asset shall be recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised, unless the deferred tax asset arises from the initial recognition of an asset or liability in a transaction that:
>
> (a) is not a business combination; and
>
> (b) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

46. Paragraph 5 of IAS 12 defines temporary differences as differences between the carrying amount of an asset or liability *in the statement of financial position* and its tax base. Applying IFRS 16, a lessee recognises a lease asset and lease liability in its statement of financial position. Therefore, in our view an entity considers the lease asset and lease liability independently of each other for the purposes of recognising deferred tax. The unit of account in IAS 12 is the separate asset and liability, and thus we think the initial recognition exemption would apply separately to the lease asset and lease liability that an entity recognises in its statement of financial position at lease commencement.

Because the entity recognises a lease asset and lease liability at lease commencement, the transaction affects neither accounting profit nor taxable profit (tax loss). Consequently, in our view if an entity determines that temporary differences arise on initial recognition of the lease asset and lease liability, the initial recognition exemption applies and the entity would not recognise deferred tax. This reflects Approach 1 in the submission.

47. Applying Approach 2 in the submission, an entity would assess the lease asset and lease liability together as a single transaction because they are 'integrally linked'. Proponents of that approach say that it is consistent with the way in which the lease transaction is viewed for tax purposes. Although we agree that, for tax purposes, the tax authority considers the lease transaction to be a single item on which it gives a single set of tax deductions, we think there is no basis for this approach in IAS 12. This is because the requirements of IAS 12 focus separately on assets and liabilities recognised for accounting purposes.

48. Approach 3 in the submission says the initial recognition exemption in IAS 12 applies only when an entity recognises an asset *or* a liability. Because in the case of leases an entity recognises an asset *and* a liability at lease commencement, Approach 3 says the conditions underlying the initial recognition exemption are not present. An entity therefore recognises a deferred tax asset and deferred tax liability for the temporary differences that arise on initial recognition of the lease asset and lease liability on a gross basis. We do not agree with the premise underlying Approach 3. We think '*or*' within the phrase 'initial recognition of an asset or liability' in paragraphs 15 and 24 of IAS 12 merely means that the condition applies equally to assets *and* liabilities recognised for accounting purposes. It does not mean that in the single transaction an entity must recognise only an asset or a liability for the condition to apply.

Decommissioning liabilities

49. As mentioned in paragraph 9 of this paper, similar to leases an entity recognises a decommissioning liability and includes in the cost of an item of property, plant

and equipment the costs of decommissioning the asset. The entity is likely to make payments to settle the decommissioning liability only at the end of the asset's useful life.

50. As discussed earlier in the paper in the context of a lease transaction, an entity needs to apply judgement having considered the applicable tax law to determine whether to attribute the tax deductions to the asset or the decommissioning liability. The accounting on initial recognition of a decommissioning liability is similar to the accounting for a lease—ie in both cases, on initial recognition an entity recognises an asset (that will be depreciated over the period of its use) and a liability typically for the same amount. Accordingly, there are similar considerations in determining the tax base of the asset and decommissioning liability as there are for a lease—paragraphs 22-30 of this paper discuss those considerations in the context of a lease. If the entity attributes the tax deductions to the asset and the future interest expense, then temporary differences would not arise on initial recognition of the asset and decommissioning liability. Accordingly, the entity would not recognise a deferred tax asset or liability on initial recognition of the decommissioning asset and liability. In contrast, if the entity attributes the tax deductions to the settlement of the decommissioning liability, then temporary differences would arise on both the asset and the decommissioning liability. In that case, we think the entity would apply the initial recognition exemption in paragraphs 15 and 24 of IAS 12 and would not recognise a deferred tax asset or deferred tax liability (for the reasons outlined in paragraph 46 of this paper).

51. Because the accounting for decommissioning liabilities and leases are similar, it is likely that an entity would reach the same conclusions regarding the tax base of the asset and liability that the entity recognises for each transaction, having considered the applicable tax law. However, it is possible that an entity might reach different conclusions based on differences in the applicable tax law.

Staff Conclusion

52. The submission asks a question about the application of the initial recognition exemption in paragraphs 15 and 24 of IAS 12 to the temporary differences that are assumed to arise from the initial recognition of a lease asset and lease liability. However, in our view the question that first needs to be asked is whether temporary differences arise on initial recognition of that asset and liability. In making that assessment, an entity determines the tax base of the lease asset and lease liability. The entity applies judgement having considered the applicable tax law to determine the amount attributable to the lease asset and lease liability for tax purposes. Determining the attribution of the tax deductions to the lease asset or lease liability is not an accounting policy choice—an entity applies judgement having considered and analysed the applicable tax law.

53. If the entity attributes tax deductions to the lease asset and future interest accrual, temporary differences do not arise on initial recognition of the lease asset and lease liability and the initial recognition exemption does not apply. This outcome is the same as that of Approach 2 and Approach 3 described in the submission, however the rationale is different.

54. If the entity attributes tax deductions to the lease liability and future interest accrual, temporary differences arise on initial recognition of both the lease asset and lease liability. The initial recognition exemption in paragraphs 15 and 24 of IAS 12 apply and, thus, the entity does not recognise a deferred tax asset or deferred tax liability. This is because the initial recognition exemption applies separately to each asset and liability recognised in the statement of financial position. This outcome is the same as that of Approach 1 described in the submission.