STAFF PAPER

IASB Meeting

Project	**Deferred tax – tax base of assets and liabilities**
Paper topic	Possible narrow-scope standard-setting

CONTACT(S)	Gustavo Olinda	golinda@ifrs.org	+44 (0) 20 7246 6481
	Jawaid Dossani	jdossani@ifrs.org	+44 (0) 20 7332 2742
	Anne McGeachin	amcgeachin@ifrs.org	+44 (0) 20 7246 6486

Introduction

1. The IFRS Interpretations Committee (Committee) received a submission about the recognition of deferred tax when a lessee recognises an asset and liability at the commencement date of a lease. 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. The submitter noted that this question will arise more often when entities apply IFRS 16 *Leases* than when applying IAS 17 *Leases*.

2. The Committee discussed the submission at its meetings in March and June 2018. It observed that, in some situations, offsetting temporary differences arise on initial recognition of assets and liabilities related to leases or decommissioning obligations. It then discussed whether an entity (i) recognises deferred taxes for these temporary differences, or (ii) applies the initial recognition exemption in IAS 12 *Income Taxes.*

3. The Committee decided to recommend that the International Accounting Standards Board (Board) propose a narrow-scope amendment to IAS 12. The amendment would narrow the applicability of the initial recognition exemption so that it would not apply to offsetting temporary differences that could arise on initial recognition of assets and liabilities related to leases or decommissioning obligations in particular situations.

4. The objective of this paper is to:

   (a) provide the Board with:

      (i) our analysis of the matter; and

      (ii) a summary of the Committee’s recommendations.

   (b) ask the Board whether it agrees with the Committee’s recommendations.

Structure of the paper

5. This paper includes:

   (a) summary of the Committee’s recommendation;

   (b) background information;

   (c) staff analysis;

   (d) Committee’s discussions and recommendations; and

   (e) question for the Board.

6. There are two appendices to this paper:

   (a) Appendix A—advance lease payments and initial direct costs; and

   (b) Appendix B—ability to recognise deferred tax assets.

Summary of the Committee’s recommendation

7. The Committee recommended that the Board proposes a narrow-scope amendment to IAS 12 so that the initial recognition exemption would not apply to transactions that give rise to both taxable and deductible temporary differences to the extent the amounts recognised for the temporary differences are the same.

Background information

8. The Committee received a submission about the recognition of deferred tax in relation to leases and decommissioning obligations.

9. 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.

10. 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.

11. Applying IAS 37 and IAS 16 *Property, Plant and Equipment*, 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.

12. An entity, therefore, generally recognises both an asset and a liability when accounting for leases and decommissioning obligations. The submitter assumed that initial recognition of these assets and liabilities 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 (reproduced in paragraph 34 of this paper) (initial recognition exemption) 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 asset and liability and, accordingly, does not recognise any deferred tax asset or liability.

(b) *Approach 2 – the asset and liability are 'integrally linked' and no temporary difference arises on initial recognition*

An entity assesses the asset and liability together on a net basis (ie as a single unit of account). On initial recognition, the net carrying amount and the net tax base of the asset and liability assessed together are both equal to nil[2]. Thus, temporary differences do not arise on initial recognition and the initial recognition exemption is not applicable.

(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 asset and liability because an entity recognises an asset *and* liability at the same time. An entity therefore recognises a deferred tax asset or liability for each gross temporary difference when it recognises the related asset and liability.

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.

14. For further details about the submission (including more information on the different approaches identified by the submitter) and the outreach performed, please refer to Agenda Paper 4 of the March 2018 Committee meeting.

[2] In the case of leases, assuming an entity has not made lease payments before lease commencement.

Staff analysis

Structure of the analysis

15. For simplicity, this paper analyses the applicable requirements in IAS 12 using leases as an example, but the analysis applies equally to decommissioning assets and liabilities. We have also assumed that the transaction or event that gives rise to the lease asset and lease liability is not a business combination[3].

16. We first analysed how an entity applies the requirements of IAS 12—our analysis is divided in the following two steps:

    (a) *step 1*: assess whether temporary differences arise on initial recognition of lease asset and lease liability; and

    (b) *step 2*: assess whether and how an entity applies the initial recognition exemption when temporary differences arise on initial recognition.

17. As a result of preliminary feedback from the Committee regarding our analysis of the applicable requirements in IAS 12 (paragraphs 41–44 of this paper), we further analysed:

    (a) the effects of applying (or not applying) the initial recognition exemption to the subsequent accounting of income taxes; and

    (b) the purpose of the initial recognition exemption and whether it is necessary in the fact pattern described in the submission.

18. We then describe the Committee's discussions and recommendations and ask whether you agree with the Committee's recommendations.[4]

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[3] The initial recognition exemption does not apply on initial recognition of an asset or liability in a business combination.

[4] The Committee did not consider the guidance in US GAAP on this matter. This is because Accounting Standards Codification (ASC) 740 *Income Taxes* does not include an initial recognition exemption as is the case in IAS 12.

Applying the requirements of IAS 12

Step 1: Assess whether temporary differences arise on initial recognition

19. As mentioned in paragraph 12 of this paper, the submission assumed temporary differences arise on initial recognition of lease assets and lease liabilities, and asked whether an entity applies the initial recognition exemption. We think this assumption will not always apply. Hence, 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.

Determining the tax base of the lease asset and lease liability

20. 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…'

21. 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:

> 7. 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.
>
> 8. 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…

22. 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.

23. 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 (see paragraphs 25–29 of this paper); or

(b) the repayment of the lease liability (see paragraph 30 of this paper).

24. 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.

Tax deductions are attributable to the lease asset

25. 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[5] applying paragraph 7 of IAS 12 (reproduced in paragraph 21 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 21 of this paper), 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 situation temporary differences do not arise on initial recognition of the lease asset and lease liability, and thus the entity does not recognise any deferred tax at lease commencement.

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

26. To illustrate, assume Lessee rents a building for five years. The lease payments are CU100[6] 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.

27. 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[7]	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)**	

28. 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 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.

[6] CU = currency unit

[7] 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.

29. 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. Accordingly, the tax base of the lease liability equals its carrying amount and a temporary difference does not arise on initial recognition of the lease liability either. In this situation—ie when an entity attributes tax deductions to the lease asset and future interest accrual, we note that the initial recognition exemption is not applicable because temporary differences do not arise on initial recognition of the lease asset and lease liability. Accordingly, the considerations discussed in step 2 of our analysis (paragraphs 33–39 of this paper) do not apply.

Tax deductions are attributable to the lease liability

30. 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. Accordingly, a temporary difference also arises on the lease asset. Step 2 of our analysis (paragraphs 33–39 of this paper) considers whether, in this situation, an entity recognises a deferred tax asset and liability for those temporary differences, or whether it applies the initial recognition exemption.

Summary of step 1

31. In assessing the question raised in the submission, we think an entity first considers whether temporary differences arise on initial recognition of the lease asset and lease 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.

32. 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. If, instead, the entity attributes tax deductions to the repayment of the principal amount of the lease liability and the future interest accrual, temporary differences arise on initial recognition.

Step 2: Assess whether and how the initial recognition exemption applies

33. When temporary differences arise on the lease asset and lease liability at lease commencement (see paragraph 30 above), an entity considers whether to recognise a deferred tax asset and deferred tax liability for those temporary differences. In making this assessment, an entity considers whether the initial recognition exemption applies.

34. Paragraphs 15 and 24 of IAS 12 discuss when an entity recognises deferred taxes and when the initial recognition exemption applies. These paragraphs 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).

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

36. 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. 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.

37. Because the entity recognises a lease asset and lease liability at lease commencement, the transaction affects neither accounting profit nor taxable profit (tax loss). Accordingly, 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 does not recognise any deferred tax asset or liability. This reflects Approach 1 in paragraph 12 of this paper.

38. Applying Approach 2 in paragraph 12 of this paper, an entity assesses the lease asset and lease liability together as a single transaction because they are 'integrally linked'. Proponents of that approach say 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 we think the requirements in IAS 12 apply separately to assets and liabilities recognised for accounting purposes.

39. Approach 3 in paragraph 12 of this paper 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, proponents of this approach say 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. 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.

Summary of step 2

40. 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. In this situation, we think the entity applies the initial recognition exemption and, thus, does not recognise a deferred tax asset or liability on initial recognition of the lease asset and lease liability. This is because an entity applies the initial recognition exemption separately to the asset and liability recognised in the statement of financial position.

Committee's preliminary discussion

41. At the Committee's March 2018 meeting, 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.

42. 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 makes that assessment.

43. Some Committee members said the diversity in reporting methods results from differing interpretations of the requirements in IAS 12 and in particular the application of the initial recognition exemption. 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, as part of the 2015 Agenda Consultation, the Board had already considered whether to add a project on IAS 12 to its work plan, and had decided not to do so. Some Committee members also raised questions about the

subsequent accounting that could result from applying the different approaches identified in the submission.

44. In exploring possible standard-setting options, and to obtain a better understanding of the underlying matter raised in the submission, we analysed:

(a) the effects of applying (or not applying) the initial recognition exemption to the subsequent accounting of income taxes; and

(b) the purpose of the initial recognition exemption and whether it is necessary in the fact pattern described in the submission.

The effects of applying (or not applying) the initial recognition exemption

The requirement to recognise deferred tax and its implications

45. To understand the effects of applying (or not applying) the initial recognition exemption on the subsequent accounting for income taxes, it is necessary to consider the fundamental principle in IAS 12. Paragraph 10 of IAS 12 states:

> …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…

46. 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.

47. In this example, the recognition of deferred tax 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.

48. To illustrate the subsequent effects of recognising (or not recognising) deferred tax, we have used the example in paragraph 46 of this paper and assumed the entity has taxable income of CU100 in the reporting period in which it acquired the asset. For simplicity, we have also assumed that the entity recognised a depreciation charge of CU50 and a tax depreciation of CU90 in that same period. The entity therefore:

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

    (b) generates taxable 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 46 of this paper).

49. 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, rather than reflecting the tax effects of recovering the asset in that 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%**

Effect of applying the requirements in IAS 12 to the fact pattern

50. Our analysis in steps 1 and 2 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 an entity applies the initial recognition exemption when such temporary differences arise.

51. To illustrate the effects of applying the initial recognition exemption to the subsequent accounting of income taxes in the situation described in the submission, we used the same example discussed in paragraph 26 of this paper. We considered the subsequent accounting when the entity attributes the tax deductions to:

    (a) the lease asset (ie depreciation expense) and future interest accrual; and

    (b) the lease liability (ie repayment of the principal portion of the lease liability) and future interest accrual.

Tax deductions attributable to the lease asset

52. Paragraphs 25–29 of this paper discuss the application of the requirements in IAS 12 when the entity attributes tax deductions from the lease payments to the lease asset. Those paragraphs illustrate that, in this situation, temporary differences do not arise on initial recognition, and therefore the initial recognition exemption does not apply.

53. In subsequent periods, however, temporary differences will likely 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. Paragraph 24 of IAS 12 (see paragraph 34 of this paper) requires an entity to recognise a deferred tax asset for all deductible temporary differences unless the initial recognition exemption applies. Because the entity does not apply the initial recognition exemption in this situation, it recognises a deferred tax asset and deferred tax income as these temporary differences arise in subsequent periods.

54. 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 (a) the pattern of recovery of the asset through depreciation; and (b) the accrual of interest over the lease liability. To illustrate this, we used the same example discussed in paragraphs 26–29 of this paper and assumed that the entity 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[8]	**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**	**-**

[8] Paragraph 25 of this paper includes the calculation of depreciation and interest expense during the lease term.

55. The following table illustrates the current tax expense calculation using the same example, but also assuming the entity recognises revenue of CU120 in each of the periods:

	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**
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**

56. 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

57. The fact pattern is the same as the one discussed in the previous example. However, in this situation the entity attributes tax deductions to the lease liability, instead of to the lease asset. For the reasons discussed in paragraphs 33–40 of this paper, we think that in this situation (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 on initial recognition of the lease asset and lease liability.

58. When the initial recognition exemption applies, paragraph 22(c) of IAS 12 does not permit an entity to recognise subsequent changes in the unrecognised deferred tax asset or liability as the asset is depreciated. Accordingly, the entity does not recognise deferred tax as it depreciates the lease asset or settles the lease liability.

59. 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 the entity does not recognise deferred tax. It shows that the net unrecognised deferred tax asset is equal, in each period, to the deferred tax asset recognised in the previous situation, as illustrated in paragraph 54 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[9]
Initial recognition	-
Year 1	1.8
Year 2	2.6
Year 3	2.6
Year 4	1.8
Year 5	-

60. Because the entity did not recognise deferred tax assets or liabilities on initial recognition of the lease asset and lease liability, 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.

	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%**

61. If the entity did not apply the initial recognition exemption, 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 56 of this paper. This is because the same net temporary difference would have existed throughout the lease term (see paragraph 59 of this paper).

[9] 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%).

Summary

62. Applying the initial recognition exemption 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.

63. As illustrated in paragraphs 57–60 of this paper, applying the initial recognition 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.

Is the initial recognition exemption necessary in the fact pattern described in the submission?

64. Because the effect of applying the initial recognition exemption in the fact pattern described in the submission is not in line with the fundamental principle in IAS 12 (see paragraph 45 of this paper), we considered the purpose of the initial recognition exemption and whether it is needed in the fact pattern described in the submission.

What is the purpose of the initial recognition exemption?

65. 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.

66. This paragraph clarifies that the purpose of the initial recognition 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 accounting profit or loss (or taxable profit or loss).

Is the initial recognition exemption needed in the fact pattern described in the submission?

67. 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.

68. 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 amounts of the lease asset and lease liability are the same on initial recognition[10] 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

[10] For the purpose of this analysis, we assumed the entity makes no advance lease payments or incurs initial direct costs on or before lease commencement. Paragraphs 82–83 of this paper consider situations in which the carrying amounts of the lease asset and lease liability are not the same on initial recognition.

same amount. Hence, there is no effect on the 'net' temporary difference, which is always nil on initial recognition.

69. In the situation described in paragraph 68(a) of this paper, the initial recognition exemption would not apply because temporary differences do not arise on initial recognition of the lease asset and lease liability.

70. 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 initial recognition exemption were not applied, an entity would have recognised a deferred tax asset and liability of the same amount.[11]

71. This means the undesirable outcome the initial recognition exemption was designed to prevent (see paragraph 65 of this paper) does not apply to 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 would it require any adjustment to the carrying amount of the related lease asset or lease liability. Therefore, in our view, the initial recognition exemption is not needed for a lease transaction. Furthermore, not applying the initial recognition exemption would result in an outcome that is more aligned with the fundamental principle in IAS 12 (see paragraph 45 of this paper).

Committee's discussions and recommendations

Exploring possible standard-setting options

72. In light of our analysis of IAS 12 and its preliminary discussion of the submission, the Committee explored two possible standard-setting options to address the matter:

    (a) *Option 1:* develop a narrow-scope amendment to IAS 12 so that the initial recognition exemption would not apply to the fact pattern described in the submission.

[11] Assuming it is probable that taxable profit will be available against which the entity can utilise the deductible temporary difference. Paragraph 82–83 of this paper considers situations in which this is not the case.

(b) *Option 2:* develop an Interpretation on how an entity applies the requirements in IAS 12 to the fact pattern described in the submission.

Option 1: Develop an amendment to IAS 12

73. The Committee observed that narrowing the application of the initial recognition exemption to exclude situations such as those described in the submission would improve IAS 12. This could be achieved by proposing a narrow-scope amendment to IAS 12 so that the initial recognition exemption would not apply to transactions that give rise to equal amounts of taxable and deductible temporary difference.

74. For such transactions, the amendment would result in recognising 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 would reflect the fundamental principle in IAS 12—see paragraphs 45–49 of this paper.

75. The amendment would also lead to an accounting outcome that is similar to those described in approach 2 and approach 3 of the submission. The Committee observed that such approaches may have developed in practice, in part, to avoid what might be viewed as an imperfect outcome of applying the initial recognition exemption (as discussed in paragraph 63 of this paper).

76. The amendment might result in entities recognising deferred tax assets and liabilities on a gross basis when temporary differences arise at initial recognition. However, 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 in the statement of financial position. Accordingly, the proposed amendment would result in a similar accounting treatment no matter how an entity determines the tax base of assets and liabilities. 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.

77. Some Committee members said implementing the proposed amendment could require some entities to incur significant additional costs in accounting for previously unrecognised deferred taxes.

Option 2: Develop an Interpretation

78. The Committee also considered developing an interpretation which would:

(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 unclear from the applicable tax law how to attribute those deductions.

Committee's recommendation—propose a narrow-scope amendment

79. The Committee decided to recommend that the Board propose an amendment to IAS 12 (as described in paragraphs 73–77 of this paper), rather than to develop an Interpretation (as described in paragraph 78). This is because the recommended amendment:

(a) would eliminate existing diversity in how entities recognise deferred tax relating 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 tax deductions to the lease asset, even though the net temporary difference arising from the transaction is the same in either case (as paragraphs 52–61 of this paper explain).

(b) would improve the subsequent accounting for the tax effects of the transaction by aligning it 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.

Application guidance on determining the tax base of assets and liabilities

80. The amendment described above would be limited to narrowing the applicability of the initial recognition 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. The Committee considered whether it should recommend providing application guidance on how an entity determines the tax base of the asset and liability (as described in paragraph 78(b)) in addition to narrowing the applicability of the initial recognition exemption.

81. Although potentially helpful in some respects, the Committee decided that such application guidance would add complexity to any standard-setting undertaken and is not required to resolve the matter 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, adding such application guidance would add limited incremental benefit.

Other considerations

82. The Committee's analysis and discussion above assume the entity:

(a) makes no advance lease payments or incurs initial direct costs on or before lease commencement; and

(b) is able to recognise deferred tax assets because it is probable that taxable profit will be available against which the entity can utilise the deductible temporary differences.

83. Appendices A and B provide detailed analysis of the implications of changing these assumptions. Based on its assessment of these matters—in particular that of changing the assumption in paragraph 82(b)—the Committee concluded that the exemption is not necessary *only to the extent* an entity would recognise a deferred tax asset and liability of the same amount.

Summary of the Committee's recommendation

84. The Committee recommended that the Board proposes a narrow-scope amendment to IAS 12 so that the initial recognition exemption would not apply to transactions that give rise to both taxable and deductible temporary differences to the extent the amounts recognised for the temporary differences are the same.

Question for the Board

Question for the Board
1. Does the Board agree with the Committee's recommendation set out in paragraph 84 of this paper?

Appendix A—advance lease payments and initial direct costs

A1. In reaching its view in paragraph 79 of this paper, the Committee assumed the entity makes no advance lease payments or incurs initial direct costs on or before lease commencement. This appendix considers any implications of changing this assumption.

A2. Applying paragraph 24 of IFRS 16, an entity recognises advance lease payments and initial direct costs as components of the cost of the lease asset (see paragraph 9 of this paper). The recognition of these items might appear to result in a difference between the amounts of taxable and deductible temporary differences arising at lease commencement. This is because advance lease payments and initial direct costs are part of the carrying amount of the lease asset, but not of the carrying amount of the lease liability.

A3. However, in the fact pattern described in the submission, tax deductions are available on a cash basis. Therefore, an entity receives tax deductions at the time it makes the advance lease payments or pays the initial direct costs. Because the entity receives tax deductions at that stage, it will not receive further tax deductions and the tax base of these components is nil. Accordingly, a taxable temporary difference arises in respect of these components of the lease asset.

A4. An entity applies the initial recognition exemption to a temporary difference arising from the initial recognition of an asset or liability if the transaction is not a business combination and if, at the time of the transaction, it affects neither accounting profit nor taxable profit. As explained in paragraph A3 of this paper, advance lease payments and the payment of initial direct costs affect taxable profit because they are deductible for tax purposes when paid. It follows that the entity cannot apply the initial recognition exemption and the entity therefore recognises a deferred tax liability when it recognises these items.

A5. At lease commencement, the entity recognises a lease liability for the present value of the future lease payments and the related component of the cost of the lease asset. This creates equal and offsetting effects in the temporary differences associated with the lease asset and the lease liability. The requirements of IAS 12 would apply to these effects as previously discussed in this paper (see paragraphs 15–71 of this paper).

A6. To illustrate the effect of making advance lease payments or incurring initial direct costs, we have used the same example discussed in paragraph 26 of this paper.

A7. In this example, 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 future lease payments on initial recognition of the lease asset and lease liability as CU435. In addition to these facts, we assumed that Lessee also makes an advance lease payment of CU100 before lease commencement and incurs initial direct cost of CU10. All payments related to the lease (including advance payments and initial direct costs) are deductible for tax purposes on a cash basis and the entity is subject to a tax rate of 20%.

A8. When Lessee makes the advance lease payments and incurs initial direct costs it records:

Dr. Asset	CU110	
Cr. Cash		CU110

(to record payment of advance lease payments of CU100 and initial direct costs of CU10)

A9. The entity receives a tax deduction of CU110 for these payments. Because the entity will receive no future tax deduction for these payments, the tax base of the related asset is nil. This results in a taxable temporary difference of CU110 (carrying amount of CU110 less tax base of nil). Because the recognition of these payments affects taxable profit, the initial recognition exemption does not apply. Accordingly, the entity recognises a deferred tax liability of CU22 (taxable temporary difference of CU110 x tax rate of 20%). The journal entry would be as follows:

Dr. Deferred tax expense	CU22	
Cr. Deferred tax liability		CU22

(to record deferred tax liability and the related deferred tax expense)

A10. At lease commencement, the entity recognises a lease liability for the present value of future lease payments and the related cost component of the lease asset. If the entity attributes tax deductions to the lease liability, equal and offsetting temporary differences of CU435 would arise. Applying the proposed amendments to IAS 12, the initial recognition exemption would not apply to the lease liability and the related component of the lease asset. Accordingly, the entity would recognise a deferred tax asset of CU87 (CU435 x 20%) and a deferred tax liability of the same amount. The journal entries would be as follows:

Dr. Right-of-use asset	CU545	
Cr. Lease liability		CU435
Cr. Asset		CU110

(to record lease liability for present value of lease payments and the right-of-use asset)

Dr. Deferred tax asset	CU87	
Cr. Deferred tax income		CU87

(to record deferred tax asset and the respective deferred tax income)

Dr. Deferred tax expense	CU87	
Cr. Deferred tax liability		CU87

(to record deferred tax liability and the respective deferred tax expense)

The deferred tax income and deferred tax expense net to nil, and thus there is no effect in profit or loss. In addition, applying paragraph 74–75 of IAS 12 would typically result in the entity offsetting the deferred tax asset and liability in the statement of financial position.

A11. Based on this analysis, the Committee concluded that removing the assumption that the entity makes no advance lease payments or incurs initial direct costs on or before lease commencement does not affect the proposed amendments.

A12. In addition, we considered whether differences between the amounts of taxable and deductible temporary differences could arise on initial recognition of lease assets and lease liabilities in other situations and assessed any related implications.

A13. We think any such differences would only arise if the lessee made advance lease payments or incurred initial direct costs. Paragraphs A2–A11 of this paper address this matter in situations in which these payments are deductible on a cash basis for tax purposes.

A14. In some situations, some initial direct costs an entity incurs may not be deductible for tax purposes. In these cases, because incurring initial direct costs affects neither accounting profit nor taxable profit, the recognition of these costs would give rise to a taxable temporary difference[12] to which the entity applies the initial recognition exemption. This is no different from the treatment that is required for any other asset that includes in its carrying amount costs that are not deductible for tax purposes (for example, an item of property, plant and equipment accounted for applying IAS 16 *Property, Plant and Equipment*). In addition, similar to the situation described in paragraph A5 above, equal and offsetting temporary differences would still arise at lease commencement when the entity recognises a lease liability and the related component of the right-of-use asset.

[12] Tax base of an asset is 'the amount that will be deductible for tax purposes…' Because the initial direct costs are not deductible for tax purposes, the tax base for these costs would be nil.

Appendix B—ability to recognise deferred tax assets

B1. In reaching its view in paragraph 79 of this paper, the Committee assumed the entity is able to recognise deferred tax assets because it is probable that taxable profit will be available against which the entity can utilise the deductible temporary differences. This appendix considers any implications of changing this assumption.

B2. Paragraphs 24 of IAS 12 (reproduced in paragraph 34 of this paper) requires an entity to recognise deferred tax assets only '…to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised…' This requirement (recoverability requirement) ensures an entity recognises deferred tax assets only when it is probable that it will be able to recover the deferred tax asset.

B3. In paragraphs 67–71 of this paper, we outlined our view that the initial recognition exemption is not necessary for a transaction that creates equal taxable and deductible temporary differences. However, there might be some situations in which equal taxable and deductible temporary differences do not result in an entity recognising equal amounts of deferred tax assets and liabilities. This would be the case if, for example, an entity is unable to recognise some portion of a deferred tax asset related to deductible temporary differences because it does not meet the recoverability requirement.

B4. An entity may meet the recoverability requirement through future reversal of taxable temporary differences. This is because the reversal of such temporary differences may give rise to taxable profits. Paragraph 28 of IAS 12 states:

> 28. It is probable that taxable profit will be available against which a deductible temporary difference can be utilised when there are sufficient taxable temporary differences relating to the same taxation authority and the same taxable entity which are expected to reverse:
>
> (a) in the same period as the expected reversal of the deductible temporary difference; or
>
> (b) in periods into which a tax loss arising from the deferred tax asset can be carried back or forward.

In such circumstances, the deferred tax asset is recognised in the period in which the deductible temporary differences arise.

How the requirements apply to leases and decommissioning obligations

B5. In the fact pattern described in the submission, it might appear that an entity would always satisfy the recoverability requirement, because the transaction (a) gives rise to the same amount of taxable and deductible temporary differences, and (b) those differences relate to the same taxation authority and taxable entity. Accordingly, it would appear that the future reversal of the taxable temporary difference would provide taxable profit against which the entity can utilise any resulting deferred tax asset. However, this might not always be the case, because the reversal of taxable and deductible temporary differences may occur in different periods, and an entity may not be able to—or might have restrictions on being able to—carry tax losses back or forward to the periods in which the taxable temporary differences reverse.

B6. In leases and decommissioning obligations, any deductible temporary difference will generally be associated with the liability and will reverse as an entity repays the liability. Similarly, any taxable temporary difference will generally be associated with the asset and will reverse as an entity recovers the asset (depreciation or impairment).

B7. In the case of leases, we would expect that, in most situations, the taxable temporary differences would reverse in a not dissimilar way to the reversal of the deductible temporary difference. This is because an entity usually makes lease payments and depreciates the lease asset throughout the term of the lease. Therefore, independent of other sources of taxable profit, we think an entity is likely to satisfy the recoverability requirement in these situations.[13]

B8. However, in the case of decommissioning obligations, there might be a greater disconnect between the recovery of the related asset and the periods in which decommissioning costs are deductible for tax purposes—this is because an entity generally only makes payments (and therefore receives tax deductions) at the end of the useful life of the asset when it starts the decommissioning activities. Depending on

[13] Our analysis in paragraphs B7–B9 considers how likely an entity would be to meet the recoverability requirement solely by considering the reversal of any related taxable temporary difference. In assessing whether it meets the recoverability requirement, an entity would also consider the probability of future taxable profits arising from other sources (for example, its own operations and tax planning opportunities).

the applicable tax laws, an entity may also be restricted in its ability to carry tax losses backwards or forward. These factors could mean that, in some cases, independent of other sources of taxable profit an entity might be unable to benefit from the future tax deductions associated with the decommissioning costs, and may not satisfy the recoverability requirement.

B9. For the reasons described in paragraphs B7–B8, we think this situation might occasionally be relevant for some decommissioning obligations but is less likely to be relevant for leases.

Effect on the proposed amendments

B10. In the light of our analysis in paragraphs B2–B9 of this paper, the Committee concluded that the initial recognition exemption is not necessary *only to the extent* an entity would recognise a deferred tax asset and liability of the same amount. This would result in an entity recognising deferred tax assets and liabilities:

(a) of the same amount; and

(b) only *to the extent* (ie up to the point) the entity would otherwise recognise a deferred tax asset considering the recoverability requirement.

B11. The Committee concluded that the initial recognition exemption continues to be required for any portion that the entity cannot offset. This is because, if an entity were to recognise any unmatched portion, the entity would have to recognise the other side of the entry either as an adjustment to the carrying amount of the related asset or liability, or as a gain or loss in profit or loss. Therefore, recognising this portion would result in the outcome that the initial recognition exemption was designed to prevent (see paragraph 66 of this paper).

Interaction with the requirement to reassess unrecognised deferred tax assets

B12. Paragraph 37 of IAS 12 requires an entity to reassess unrecognised deferred tax assets at the end of each reporting period. An entity recognises a previously unrecognised deferred tax asset to the extent that is has now become probable that future taxable profits will allow the entity to recover the deferred tax asset (for example, because of an improvement in trading conditions).

B13. In this section, we consider how this requirement applies to an entity that does not, at initial recognition of a decommissioning obligation, meet the recoverability requirement (see paragraph B8 of this paper).

B14. In analysing this question, we first assessed more generally how an entity applies the requirements in paragraph 24 of IAS 12 (reproduced in paragraph 34 of this paper) to any transaction in which the entity, on initial recognition:

(a) does not satisfy the recoverability requirement; and

(b) meets the conditions to apply the initial recognition exemption (ie the transaction is not a business combination and at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss)).

In these situations, an entity would not recognise a deferred tax asset when it initially recognises the transaction.

B15. IAS 12 does not specify whether an entity first considers the initial recognition exemption or the recoverability requirement when assessing whether to recognise a deferred tax asset. Accordingly, we think an entity could take different views as to whether it did not recognise deferred tax because of (a) the recoverability requirement, or (b) the initial recognition exemption. This is important because the subsequent accounting for deferred tax could vary depending on which of the two requirements takes precedence.

B16. If an entity considers that it does not recognise deferred tax assets because of the initial recognition exemption, it will also not recognise deferred tax subsequently (see paragraph 58 of this paper). Accordingly, in this situation the entity does not recognise a deferred tax asset regardless of whether it subsequently meets the recoverability requirement.

B17. If, on the other hand, an entity considers that it does not recognise deferred tax assets because of the recoverability requirement, it follows that the entity applies paragraph 37 of IAS 12 and subsequently reassess any unrecognised deferred tax asset. An entity might, as a result of this reassessment, conclude that it should subsequently recognise a deferred tax asset in this situation.

B18. We think entities with similar fact patterns could reach different conclusions because IAS 12 does not specifically address this situation. We therefore considered whether the Board should address this matter as part of any proposed amendments to IAS 12.

B19. We think the Board should not specifically address this matter as part of any proposed amendments. This is because:

(a) addressing this matter would be broader in scope than the proposed amendments and would affect transactions other than leases and decommissioning obligations. The proposed amendments are narrow in scope and aim only to narrow the applicability of the initial recognition exemption to situations in which it is necessary (see paragraph 43 of this paper).

(b) based on our analysis in paragraphs B5–B9 of this paper, we think this situation would generally be relevant only in the case of decommissioning obligations and would arise only in very specific situations. We therefore think that addressing this broader-scope matter would add significant complexity to the project with limited incremental benefit.