Project **Income Tax**

Topic **Sweep issues on the pre-ballot draft *Deferred Taxes: Recovery of Underlying Asset***

Appendix A – Other issues raised by constituents

Issue 6 – Should the exception be applied to other assets?

Proposals in the pre-ballot draft

A1. In the pre-ballot draft, the Board proposed to <u>require</u> the exception to be applied if a taxable temporary difference is created by:

(a) measurement of investment property after initial recognition using the fair value model in IAS 40;

(b) revaluation of property, plant and equipment or intangible assets using the revaluation model in IAS 16 or IAS 38; or

(c) initial measurement of investment property, property, plant and equipment or intangible assets acquired in a business combination in accordance with IFRS 3, if the acquirer will subsequently use the fair value model in IAS 40, or the revaluation model in IAS 16, or IAS 38, for those underlying assets.

Related concerns raised by constituents

A2. Constituents raised concerns that the Board's rationale for introducing the exception relates to the difficulty and subjectivity in determining the expected manner of recovery of the underlying asset, but that rationale may also apply to other assets that are not included in the proposed scope.

A3. For example, some believe that this exception should apply to financial assets which are measured at fair value, and property, plant and equipment, or intangible assets, that are not accounted for using the revaluation model.

Staff recommendations for addressing these concerns

A4. The staff recommend the Board does not extend the scope of the proposed exception beyond that proposed in the pre-ballot draft.

A5. However, the staff note following potential consequences of entities applying the exception to property, plant and equipment or intangible assets recognised at fair value using the revaluation model in IAS 16 or IAS 38:

(a) when a taxable temporary difference arises as a result of the revaluation, an entity will recognise a deferred tax liability using the tax rate to be applied to future sale in other comprehensive income and will reverse it though profit or loss in subsequent years using the same sale rate, resulting in reporting a difference between the sale rate and an ordinary rate in a tax reconciliation disclosure if a sale is different from an ordinary rate; and

(b) when a deductible temporary difference arises as a result of the revaluation, an entity will recognise a deferred tax asset based on tax consequence of a sale in other comprehensive income only to the extent that taxable temporary difference or probable future taxable profit are available to offset against a capital loss that would occur when the related asset is recovered.

Issue 7 – Should the exception also be applied when assets are measured at fair value in a business combination and subsequently measured using a cost model?

Proposals in the pre-ballot draft

A6. In the pre-ballot draft, the Board proposed applying the exception to taxable temporary differences created by the initial measurement of investment property, property, plant and equipment or intangible assets, acquired in a business combination in accordance with IFRS 3.

A7. However, the exception would apply **only if** the acquirer will subsequently use the fair value model in IAS 40, or the revaluation model in IAS 16 or IAS 38, for those assets.

Related concerns raised by constituents

A8. Constituents expressed views that:

(a) determination of the expected manner of recovery is also difficult and subjective when assets acquired in a business combination are subsequently measured using a cost model; and

(b) the nature of the accounting policy applied by the entity after acquiring the asset (eg cost, or fair value/revaluation) should not impact the accounting for deferred taxes arising as a result of a business combination.

Staff recommendations for addressing these concerns

A9. The staff recommend updating the Basis for Conclusions to explain that:

(a) if the exception were applied to assets that are subsequently measured using the cost model, entities would be required to measure deferred tax assets or liabilities relating to those assets based on the tax consequences of sale in a business combination.

The entity would then remeasure them based on the tax consequences that follow the entity's expected manner of recovery at the end of the reporting period. This may result in the entity recognising a gain or loss after the business combination if the subsequent measurement basis is recovery through use, rather than sale of the underlying asset.

(d) in accordance with paragraph 15 of IFRS 3, an entity is required to classify or designate assets at the acquisition date. The staff believe that this would include determining whether assets acquired would be subsequently fair valued or revalued in accordance with IAS 16, IAS 38 or IAS 40.

Issue 8 – Computation of tax consequences of a sale may be complex

Proposals in the pre-ballot draft

A10. In the pre-ballot draft, the Board proposed to measure, in specific circumstances, deferred tax liabilities based on the tax consequences of recovering the carrying amount of an underlying asset entirely by sale or, if lower, the tax consequences of recovering the underlying asset entirely by use.

Related concerns raised by constituents

A11. Concerns were raised by constituents that the proposed exception will increase entities' administrative burden. This is because it requires them to compute two tax consequences, both the tax consequences of sale, and of use. This may be challenging in some jurisdictions when computation of calculating the tax consequence of recovery through sale is complex.

A12. For example, tax law sometimes requires taking into account the price index, or the market price, of the underlying asset at a previous point in time when calculating the tax consequence of recovery through sale. Sometimes an entity may have to choose the most favourable method to compute tax deductions out of two or more methods permitted by the rules established by the taxation authorities.

Staff recommendations for addressing these concerns

A13. The staff recommend that the measurement of deferred tax assets and deferred tax liabilities should reflect the tax consequence of sale rather than the lower tax consequences of sale or use. Therefore, if the Board agree with the staff recommendation, entities will not be required to compute two tax consequences for one underlying asset.

A14. The staff think that the benefit of providing the exception outweighs potential increases in administrative burden for some entities because the purpose of the exception is to provide the least subjective manner to measure deferred tax liabilities.

Issue 9 – Tax Planning Opportunity

Proposals in the pre-ballot draft

A15. In the pre-ballot draft, the Board proposed to:

(a) amend paragraphs 28 and 36 of IAS 12 to clarify that a deferred tax asset can be recognised because of the existence of a taxable temporary difference **only** when a deferred tax liability is recognised for that taxable temporary difference; and

(b) add another example in paragraph 30(e) to clarify that taking action to recover the underlying asset in one manner, eg by use, when the measurement of a deferred tax liability arising from that underlying asset assumes that the entity will recover the carrying amount of that underlying asset in another manner, eg by sale, may be considered a tax planning opportunity.

A16. The Board proposed the above amendments in order to respond to a concern that if the exception is introduced, an entity may no longer be able to fully recognise a deferred tax asset if recognition relies on the existence of taxable temporary differences to which the proposed exception applies.

Related concerns raised by constituents

A17. The following concerns were raised by constituents in relation to the proposed amendments relating to tax planning opportunities:

(a) The amendments to paragraphs 28 and 36 could have broader implications and unintended consequences on current practice.

For example, when an entity's recognition of a deferred tax asset relies on the existence of taxable temporary differences to which the initial recognition exception applies, it may no longer be able to recognise the deferred tax asset if these amendments are made.

(b) The new example added to paragraph 30(e) is confusing and unnecessary.

For example, it may assume an entity expects to **use** the underlying asset but, by applying the proposed exception, it measures a deferred tax liability based on the recovery of the underlying asset through **sale**. In that situation, an entity's action to use the underlying asset is not a tax planning opportunity because, without any specific action, the entity will generate taxable profit through expected use of the underlying asset.

(c) The proposed example in paragraph 30(e) also implies that a deferred tax asset can be recognised based on the existence of a taxable temporary difference that is greater than the amount of deferred tax liability that the entity recognises for the same taxable temporary difference.

Staff recommendations for addressing these concerns

A18. The staff recommend updating the exposure draft by removing the proposed amendments relating to tax planning opportunities because the proposed amendments:

(a) aimed to create clarity but, instead, seemed to have created confusion; and

(b) are not necessary because they were just clarification and were not intended to change the current requirements in IAS 12.

A19. Instead, the staff recommend that the exposure draft clarifies that entities should continue to use the existing principles in IAS 12 in assessing the recoverability of deferred tax assets, and the applicability of tax planning opportunities.

Issue 10 – Retrospective application

Proposals in the pre-ballot draft

A20. In the pre-ballot draft, the Board proposed to apply the amendment retrospectively without any transitional guidance.

Related concerns raised by constituents

A21. Some constituents thought that the retrospective application may be challenging in some situations. For example, if the proposed amendments require a change in deferred tax assets or deferred tax liabilities recognised in relation to underlying assets acquired in a business combination, it will lead to a change in goodwill, including entities' impairment assessments in previous reporting periods.

Staff recommendations for addressing these concerns

A22. The staff do not recommend changing the proposals for the full retrospective application of the amendment to IAS 12. This is because, although it may add some administrative burden if a change is needed for previous business combinations, the staff think that it would still not be unduly burdensome for entities to apply the proposed changes to IAS 12 retrospectively. The staff think that this cost is outweighed by the benefit of consistent application of the amendment by entities to all periods presented in the financial statements.

Appendix B – Alternative approach

Introduction

A23. The pre-ballot draft reflected the Board's tentative decision in July 2010 to propose an exception to IAS 12. This proposed measuring a deferred tax liability based on the lower tax consequence of sale or use when the exception applies.

A24. The staff has recommended in this agenda paper some changes to the proposals in the pre-ballot draft. The staff believe that the most significant is to change the measurement basis from the 'lower of' approach to the 'presumed sale' approach.

A25. However, if the Board would like to maintain the measurement basis based on the 'lower' approach, the staff proposes the following alternative to the Board proposals in the pre-ballot draft.

A summary of the alternative approach

Major issues identified in the feedback	**Staff preferred approach ('presumed sale')**	**Alternative approach ('lower of')**
• Shall the exception be applied to deferred tax assets in addition to deferred tax liabilities?	• Yes.	• Yes.
• How shall deferred taxes be measured when the exception applies?	• Based on the tax consequence of sale.	• Deferred tax liabilities - based on the lower tax consequences of sale or use. • Deferred tax assets – based on the higher tax consequences of sale or use.

• What are the implications for SIC 21 *Income taxes — Recovery of Revalued Non-Depreciable Assets* after the amendment?	• Superseded.	• Retained without amendment. • Scope of alternative approach excludes underlying assets that are in scope of SIC 21.
• What shall be the unit of account to apply the exception?	• All temporary differences relating to the underlying asset, including those not directly relating to the revaluation.	• All temporary differences relating to the underlying asset, including those not directly relating to the revaluation.
• Shall the exception be required?	• Required unless an entity will consume the asset's future economic benefit entirely throughout its economic life.	• Required unless; (1) the underlying asset is in scope of SIC 21; or (2) it is practical to determine the manner in which the entity expects to recover the carrying amount of an asset.

Concerns with applying the alternative 'lower of' approach

Deferred tax assets

A26. If the Board prefers the alternative 'lower of' approach to the 'presumed sale' approach that the staff recommend, the staff believe that the Basis for Conclusions would explain that the:

(a) rationale for using the 'lower of' approach for deferred tax liabilities should be a view that an entity has an obligation that it cannot avoid paying in the future. Any additional liability for future tax obligations should be recognised when an entity takes an action to incur that additional liability.

(b) use of the 'lower of' approach for deferred tax liabilities, is consistent with use of the 'higher of' approach for deferred tax assets. Assume a situation when a taxable temporary difference arises if the asset will be sold and a deductible temporary difference arises if the asset will be used. An entity can not get an answer if the 'lower of' approach is used for both the deferred tax asset and the deferred tax liability.

(c) rationale for using the 'higher of' approach for deferred tax assets is a view that an entity has an option to get the higher tax benefit and there is economic rationale for an entity performing an action to maximise tax benefits.

SIC 21

A27. In applying the alternative approach, the staff think that the Board should retain SIC 21 unchanged, and entities should be required to continue to apply SIC 21 to non-depreciable assets.

A28. The staff are concerned that the existence of the exception, and the guidance in SIC 21, may be viewed by some as being confusing and complex.

Requirement to apply the exception

A29. The staff are also believe that, in response to comments from constituents, the exception should not apply when it is practical to determine the manner in which the entity expects to recover the carrying amount of an asset.

A30. However the staff believe that concerns may exist when drafting language to address this issue that does not:

(a) create structuring opportunities; or

(b) lead to unintended scoping consequences.