Project	**Agenda decision**
Topic	**IAS 12 *Income Taxes*—Recognition of deferred tax assets for unrealised losses on available-for-sale debt securities (supplementary issue)**

Introduction

1. In the course of the staff analysis of the issue in agenda paper 3, the staff was informed by a constituent that entities in practice recognise a deferred tax asset based on future accounting profit rather than future taxable profit.

2. This paper discusses this supplementary issue.

Analysis

3. This constituent asked whether entities in practice recognise a deferred tax asset based on future accounting profit rather than future taxable profit using the following example.

4. Consider a deductible temporary difference that arises from income received in advance (CU 200). Assume an entity has no other income in both year 1 and year 2. If the income is taxed in year 1 and recognised for financial statement purposes in year 2, a deductible temporary difference exists in year 1. In year 2, an entity recognises income for accounting purposes but recognises nil taxable profit because of a reversal of the deductible temporary difference in year 2.

	Year 1	Year 2

Accounting profit	0	200
Deductible temporary difference - Income received in advance	200	(200)
Taxable profit	200	0

5. When considering this example, the staff was informed that entities in practice recognise a deferred tax asset on the deductible temporary difference in year 1 solely based on accounting profit in year 2, although IAS 12 requires taxable profit to recognise a deferred tax asset. In this example, taxable profit will be reduced to nil as a result of reversing the temporary difference.

6. At the end of Year 1, there is a deductible temporary difference of CU200. This is assessed against future taxable profit in accordance with IAS 12.24. The staff think that the taxable profit used is not zero in the above example. This is because this amount already reflected the deduction of the deductible temporary difference. The assessment should be made against taxable profit before deduction of the deductible temporary difference (ie CU 200 in the above example). Otherwise, the deduction is double counted.

7. Applying the above analysis to the case of the unrealised loss on AFS debt security, taxable profit used for assessing a deferred tax asset may be taxable profit before a reduction relating to reversal of the unrealised loss from accounting profit (or from comprehensive income) in computation of taxable profit.

8. The main request relating to deferred tax assets for unrealised loss on AFS debt securities asked for guidance in a situation when the entity may have insufficient taxable temporary differences and insufficient probable future taxable profits against which the deductible temporary difference can be utilised.

9. The staff understand that ‘insufficient taxable profits’ described in the request is those before a reduction relating to reversal of the unrealised loss from accounting profit (or from comprehensive income) in computation of taxable profit.

10. The staff would like to put the following questions to the Committee:

Question 1
Does the Committee agree that, in the context of the example above, the applicable future taxable profits against which an assessment should be made about whether to recognise a deferred tax asset are those before a reduction relating to reversal of the unrealised loss from accounting profit (or from comprehensive income)?

11. The staff observed during the outreaching activities that there is some confusion about what 'taxable profit' should be used when assessing deferred tax assets.

12. If the Committee also think it confusing and in need of clarification, the staff propose to clarify this through *Annual Improvements*.

13. The staff note US GAAP includes some clarifying words which could be considered for inclusion in IAS 12.29. US GAAP Topic 740-10-30-18 states;

> … The following four possible sources of taxable income may be available under the tax law to realize a tax benefit for deductible temporary differences and carryforwards:
>
> a. Future reversals of existing taxable temporary differences
>
> b. Future taxable income ***exclusive of reversing temporary differences and carryforwards***
>
> c. Taxable income in prior carryback year(s) if carryback is permitted under the tax law
>
> d. Tax planning strategy (see paragraph 740-10-30-19) that would, if necessary, be implemented to, for example:
>
> 1. … (***Emphasis added***)

14. The staff included the proposed wording for the *Annual Improvement* in Appendix A.

Staff recommendation

15. The staff recommend to clarify that 'taxable profit' to be used in assessment of deferred tax assets should be those exclusive of reversal of temporary differences and carryforwards.

***Annual Improvements* criteria assessment**

16. Below, the staff conduct an assessment of the inclusion of the issue against the proposed enhanced criteria for *Annual Improvements*:

    (a) The proposed amendment has one or both of the following characteristics:

        (i) clarifying—the proposed amendment would improve IFRSs by:

        - clarifying unclear wording in existing IFRSs, or
        - providing guidance where an absence of guidance is causing concern.

        A clarifying amendment maintains consistency with the existing principles within the applicable IFRSs. It does not propose a new principle, or a change to an existing principle.

        (ii) correcting—the proposed amendment would improve IFRSs by:

        - resolving a conflict between existing requirements of IFRSs and providing a straightforward rationale for which existing requirement should be applied, or
        - addressing an oversight or relatively minor unintended consequence of the existing requirements of IFRSs.

        A correcting amendment does not propose a new principle or a change to an existing principle, but may create an exception from an existing principle.

    (b) The proposed amendment has a narrow and well-defined purpose, ie the consequences of the proposed change have been considered sufficiently and identified.

    (c) It is probable that the IASB will reach conclusion on the issue on a timely basis. Inability to reach agreement on a timely basis may indicate that the cause of the issue is more fundamental than can be resolved within annual improvements.

    (d) If the proposed amendment would amend IFRSs that are the subject of a current or planned IASB project, there must be a pressing need to make the amendment sooner than the project would.

17. In the staff's opinion, the issue satisfies the above proposed *Annual Improvements* criteria:

    (a) The staff think that the change proposed is a clarification of how deferred tax assets are assessed in practice. It would clarify unclear words in existing IAS 12 without changing the principle in IAS 12 and without creating a new principle in IAS 12.

(b) In the staff's opinion, the change proposed is not expected to produce unintended consequences.

(c) The staff think that the Board could reach a conclusion on a timely basis on this issue.

(d) Income Tax project includes, in its scope, introduction of a concept of a valuation allowance and guidance on assessing the need for a valuation allowance. However, the staff believe that there is a pressing need to clarify this through *Annual Improvements* sooner than the project would.

18. The staff would like to put the following question to the Committee:

Question 2
Does the Committee agree with the staff recommendation?

Appendix A – Proposal for the Annual Improvement

A1 The staff proposes the following amendment to IAS 12 as a part of *Annual Improvements*.

Paragraphs 29 is amended (new text is underlined).

29 When there are insufficient taxable temporary differences relating to the same taxation authority and the same taxable entity, the deferred tax asset is recognised to the extent that:

(a) it is probable that the entity will have sufficient taxable profit, exclusive of reversing temporary differences and carryforwards, relating to the same taxation authority and the same taxable entity in the same period as the reversal of the deductible temporary difference (or in the periods into which a tax loss arising from the deferred tax asset can be carried back or forward). In evaluating whether it will have sufficient taxable profit in future periods, an entity ignores taxable amounts arising from deductible temporary differences that are expected to originate in future periods, because the deferred tax asset arising from these deductible temporary differences will itself require future taxable profit in order to be utilised; or

(b) tax planning opportunities are available to the entity that will create taxable profit in appropriate periods.