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Project **Annual Improvements (2010 – 2012 cycle)**

Topic ***IAS 12 Income Taxes: Deferred Tax for Unrealised Losses on AFS Debt Securities***

Purpose of this paper

1. The purpose of this staff paper is to ask the Board to consider as part of the *Annual Improvements Process* (AIP) clarifications in IAS 12 relating to assessment of deferred tax asset for unrealised losses on the available-for-sale (AFS) debt securities.

2. This paper provides:

   (a) explains the issue;

   (b) provides background information;

   (c) analyses the issue raised;

   (d) makes a staff recommendation for a proposed amendments to IAS12; and

   (e) asks the Board whether they agree with the staff recommendation.

The issue

3. In March 2010, the IFRS Interpretation Committee ('Committee') received a request relating to how an entity determines, in accordance with IAS 12 *Income Taxes*, whether to recognise a deferred tax asset relating to unrealised losses on AFS debt securities.

4. The request identified a situation when an entity:

   (a) holds AFS debt securities with an original cost and tax base of CU200 but a fair value of only CU150 at the reporting date;

   (b) has the ability and intent to hold the AFS debt securities to receive the future contractual cash flows until the loss of CU50 reverses (which may be at maturity of the AFS debt securities); and

   (c) has insufficient taxable temporary differences and no other probable taxable profits against which the temporary difference of CU50 relating to the AFS debt securities can be utilised.

5. In this situation, the entity identifies a deductible temporary difference of CU50 at the reporting date, relating to the difference between the tax base of CU200 and the fair value of CU150. The request asks whether the entity is able to recognise a deferred tax asset for that deductible temporary difference of CU50 in applying IAS 12 because the specific loss of CU50 relating to the AFS debt securities is expected to reverse, even though the entity has no other probable taxable profits against which this loss could be utilised.

6. The request asked the following two questions in order to provide guidance in this circumstance:

   (a) Should the entity assess whether a deferred tax asset, relating to the deductible temporary difference of CU50, can be recognised on a separate basis, rather than not be recognised as a result of assessment in combination with other deductible temporary differences?

   (b) Should the entity consider its ability and intent to hold the AFS debt securities until the loss of CU50 reverses as a tax planning opportunity?

7. We conducted outreach activities and noted that;

   (a) the first question was asked specifically in a jurisdiction in which tax law distinguish capital gain and capital loss from other taxable profit and permit offsetting the capital loss only against future capital gain; and

(b) The second question should more widely be understood as a question of whether an entity's action to hold the AFS debt security until a loss reverses should be considered a source of taxable profits.

8. Although the issue identified in the request is in the context of financial assets recognised and measured in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*, a similar issue may also arise within the context of IFRS 9 *Financial Instruments*.

Background information

9. We are aware that similar issues have been discussed in the context of US GAAP.

10. According to a request letter submitted to the FASB[1], the SEC began discussing this issue in late 2008 following a request from certain US GAAP preparers. The SEC staff concluded that they would not object to the application of either of following views:

    (a) The deferred tax asset for unrealised loss on AFS debt security should be recognised as a result of its assessment separately from other deferred tax assets (View 1)

    (b) The deferred tax asset for unrealised loss on AFS debt security should not be recognised as a result of its assessment in combination of other deferred tax assets (View 2)

11. This led to the issue being discussed by the EITF Agenda Committee in early 2009[2] and subsequent discussions by the FASB. The FASB decided in March 2010 to support View 2 (combined assessment) and included the following guidance in the exposure draft *Accounting for Financial Instruments* and its Basis for Conclusions.

[1] Reference Number 1600-DTU in the FASB Website (FASB Home - Projects - Comment Letters)
[2] Emerging Issues Task Force Meetings on January 15 and March 19, 2009.

Deferred Tax Assets

35. An entity shall evaluate the need for a valuation allowance on a deferred tax asset related to a financial instrument for which qualifying changes in fair value are recognized in other comprehensive income ***in combination with*** the entity's other deferred tax assets. (See Topic 740 for guidance on accounting for income taxes.)

Background Information, Basis for Conclusions, and Alternative Views

BC166. The Board concluded that the assessment of a valuation allowance for a deferred tax asset relating to the change in fair value recognized in other comprehensive income of debt instruments measured at fair value with qualifying changes in fair value recognized in other comprehensive income should be performed in combination with other deferred tax assets and liabilities of the entity. The Board believes that deferred tax assets relating to the change in fair value of debt instruments measured at fair value with qualifying changes in fair value recognized in other comprehensive income should be accounted for consistently with other deferred tax assets and liabilities recognized for items recognized in other comprehensive income under Topic 740 on income taxes. The Board also believes this approach would be consistent with Topic 740's requirements that the ultimate income tax calculation be based on the entity's entire tax position. Therefore, the Board believes that the tax calculation should not be segregated by tax amounts on the entity's specific assets and liabilities.

The Board discussed alternative methods for assessing a valuation allowance for a deferred tax asset.

The Board decided that deferred tax asset valuations on debt instruments measured at fair value with changes recognized in other comprehensive income should be evaluated ***in combination with*** other deferred tax assets of an entity. (Vote 5-0) (***emphasis*** added)

12. We understand that the FASB discussed and included in the exposure draft *Accounting for Financial Instruments* the guidance relating to the first question regarding the combined base assessment or separate base assessment, but not to the second question regarding a source of taxable profits.

Staff Analysis

Should the entity assess a deferred tax asset, relating to the unrealised loss on the AFS debt securities separately rather than in combination with other deductible temporary differences?

View 1 – Separate assessment

13. We understand that proponents of View 1 believe that the assessment of whether a deferred tax asset, relating to the deductible temporary difference of CU50, can be recognised should be performed separately from the assessment of other deductible temporary differences. This is because:

    (a) the deferred tax asset relating to the CU50 deductible temporary difference is expected to reverse through the passage of time without affecting future taxable profits; and

    (b) they analogise to the practice in US GAAP of analysing the character of income (eg ordinary income or capital gain) when assessing the future realisation of an existing deductible temporary difference.

14. Consequently, we understand that supporters of this view believe that an entity can recognise a deferred tax asset relating to the CU50 deductible temporary differences even though the entity expects no other probable taxable profits against which other temporary differences can be utilised.

View 2 – Combined assessment

15. We understand that proponents of View 2 believe that the assessment of whether a deferred tax asset, relating to the deductible temporary difference of CU50, can be recognised should be performed in combination with other deductible temporary differences. This is because:

    (a) IAS 12, in paragraphs 24 to 31, requires an entity to recognise a deferred tax asset only to the extent that it is probable that taxable profit is available against which the deductible temporary differences can be utilised;

(b) taxable profit against which deductible temporary differences can be utilised is determined in accordance with the rules established by the taxation authorities (tax law) upon which income taxes are payable or recoverable[3]; and

(c) tax law generally requires assessment of taxable profit on an entity basis without segregating each temporary difference.

16. However, if tax law restricts utilisation of tax losses to the same character of income, proponents of this view think that a deferred tax asset should be assessed in combination with others deductible temporary differences of the same character. In other words, we understand that supporters of this view believe that IAS 12 requires a separate assessment of each type of taxable profit for which tax law requires separate assessment on an entity basis.

Should the entity consider an action to hold the AFS debt securities until the loss of CU50 reverses as a tax planning opportunity?

17. The term, tax planning opportunity is a special term defined in IAS 12 and used only in the context of IAS 12. This term is not used in IAS 12 as a strategy or opportunity to reduce a tax liability. IAS 12.30 states that:

> Tax planning opportunities are actions that the entity would take in order to ***create or increase taxable income*** in a particular period before the expiry of a tax loss or tax credit carryforward. (***emphasis*** added)

View A – this action is a tax planning opportunity

18. We understand that proponents of this view argue that the entity's intent and ability to hold the AFS debt securities until the loss of CU50 reverses is akin to a tax planning opportunity as defined in IAS 12.30. This is because the strategy of holding the instrument prevents a tax loss being realised.

[3] IAS12.5

19. We understand that they believe that preventing a tax loss being realised has the same effect as creating taxable income to utilise the realised tax loss and, therefore, it should have the same deferred tax consequences.

View B – this action is not a tax planning opportunity

20. We understand that proponents of this view do not believe that the entity's ability and intent to hold the AFS debt securities until the loss of CU50 reverses is a tax planning opportunity.

21. They read IAS 12.30 to strictly require an action to create or increase taxable income in the future. The action of the entity in holding the AFS debt security until the loss of CU50 reverses prevents the tax loss from being realised, but does not create or increase taxable income.

22. They believe that IAS 12 does not allow recognition of a deferred tax asset based on an action that is not a tax planning opportunity even though it may be akin to it.

View C – this action is not a tax planning opportunity but creates other source of taxable profit

23. During the outreach activities, a constituent asked us whether entities in practice recognise a deferred tax asset based on future <u>accounting</u> profit rather than future <u>taxable</u> profit using the following example.

24. 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 because a tax base of income received in advance is zero while its carrying amount is CU200. 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

25. We understand that proponent of this view believe 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 in order to recognise a deferred tax asset. In this example, taxable profit will be reduced to nil as a result of reversing the temporary difference.

26. We think that they thought that taxable profit was accounting profit because taxable profit in assessing a deferred tax asset should be the amount before deduction from reversal of the deductible temporary difference. In the above example, the taxable profit in year 2 should be CU 200 rather than zero. Otherwise, the deduction would be double counted.

27. If the above proposition is applied to the case of the unrealised loss on AFS debt security, taxable profit used for assessing a deferred tax asset should be taxable profit before a deduction[4] relating to reversal of the unrealised loss. Therefore, when an entity expects to have taxable profit of nil after reversal of the unrealised loss (50), it should be considered having taxable profit in the amount of 50 for the purpose to assess a deferred tax asset.

[4] A deduction in this context means a subtraction in computation of taxable profit starting from accounting profit (ie total comprehensive income).

Staff recommendation

Should the entity assess a deferred tax asset, relating to the unrealised loss on the AFS debt securities separately rather than in combination with other deductible temporary differences?

28. We support View 2 – combined assessment.

29. We believe that paragraph 24 of IAS 12 requires an entity to assess, in accordance with tax law, whether a deduction as a result of reversal of deductible temporary differences can be offset against future taxable income. Tax law generally requires computation of taxable profits on an entity basis without segregating each temporary difference.

30. When tax law restricts utilisation of tax losses to the same character of income (ie capital gain and ordinary income), we believe that a deferred tax asset should be assessed in combination with others of the same character.

31. US GAAP includes some clarifying words which could be considered for inclusion in IAS 12.24 (Deductible temporary differences) and 34 (Unused tax losses and unused tax credits). US GAAP Topic 740-10-30-18 states:

> Future realization of the tax benefit of an existing deductible temporary difference or carryforward ultimately depends on the existence of sufficient taxable income of ***the appropriate character (for example, ordinary income or capital gain)*** within the carryback, carryforward period available under the tax law. (***emphasis*** added)

32. Therefore, we recommend to add additional words to clarify that separate assessment should be made to each type of taxable profit if tax law specifically distinguishes a specific type of profit (eg capital gains) from other types of taxable profit.

Should the entity consider an action to hold the AFS debt securities until the loss of CU50 reverses as a tax planning opportunity?

33. We support View C - not a tax planning opportunity but creates other source of taxable profit.

34. We believe that paragraph 30 of IAS 12 does not permit an entity to recognise a deferred tax asset based on an action that does not qualify as a tax planning opportunity even though such an action is akin to it.

35. We also believe that it is clear that the assessment should be made against taxable profit exclusive of reversal of deductible temporary difference in order to avoid double counting the deduction.

36. 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:
>
> … (***Emphasis added***)

37. Therefore, we recommend to add additional words to clarify that;

    (a) an action that results in reversal of existing deductible temporary differences without creating or increasing taxable profit in the future is not a tax planning opportunity; and

    (b) taxable profit against which realisation of a deferred tax asset is assessed is the amount before reversal of deductible temporary differences.

Annual Improvements criteria assessment

38. Below, we conduct an assessment of the inclusion of the issue against the enhanced criteria for assessing *Annual Improvements* included in the **IASB *Due Process Handbook***:

    (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.

    (b) The proposed amendment is well-defined and sufficiently narrow in scope such that the consequences of the proposed change have been considered.

    (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.

39. In our opinion, the issue satisfies the above proposed *Annual Improvements* criteria because:

(a) We think that the changes proposed would clarify unclear words in existing IAS 12 without changing the principle in IAS 12 or creating a new principle.

(b) We do not expect the changes proposed to produce unintended consequences.

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

(d) The Income Tax project includes, in its scope, guidance on assessing the need for a valuation allowance including guidance on tax planning opportunities. However, in our view, there is a need to clarify this through *Annual Improvements* sooner than the project would.

40. The Committee concluded that the *Annual Improvements* is a desirable approach. This is because the significant contrary views that have been adopted in practice suggest that IAS 12 is not sufficiently clear on this matter. The Committee thinks that the wording in Appendix A will provide additional clarity in IAS 12 and, therefore, satisfies the *Annual Improvements* criteria.

Effective date and transition

41. We propose that an entity shall apply the amendments retrospectively for annual periods beginning on or after 1 January 2013. Earlier application shall be permitted. If an entity applies the amendment for an earlier period it shall disclose that fact.

42. We do not think that any transitional relief is necessary, because we do not foresee any difficulty to apply the amendments retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Consequential amendments

43. We do not identify other IFRSs that need to be amended as a consequence of the proposed amendments to IAS 12.

Questions to the Board

44. The Committee discussed this issue and agreed to recommend that the Board should add this issue to the *Annual Improvements* process (2010-2012 cycle). We would like to put the following questions to the Board:

Question 1: Proposed amendment to IAS 12
Does the Board agree with the staff analysis and the proposed amendment to IAS 12 in Appendix A?

Question 2: Adding to the *Annual Improvement* process
Does the Board agree with the staff recommendation to add the proposed amendments to the *Annual Improvements* project (2010 – 2012 cycle)?

Question 3: Proposed effective date and transition
Does the Board agree with the proposed effective date and transition?

Appendix A - Proposed amendment to IAS 12 *Income Taxes*

Paragraphs 24, 29, 30 and 34 are amended (new text is underlined and deleted text is struck through).

24 A deferred tax asset shall be recognised for all deductible temporary differences to the extent that it is probable that taxable profit <u>of the appropriate character (for example, ordinary income or capital gain)</u> 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).

However, for deductible temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, a deferred tax asset shall be recognised in accordance with paragraph 44.

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, <u>exclusive of reversing temporary differences,</u> 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.

30 Tax planning opportunities are actions that the entity would take in order to create or increase taxable income in a particular period before the expiry of a tax loss or tax credit carryforward. For example, in some jurisdictions, taxable profit may be created or increased by:

(a) electing to have interest income taxed on either a received or receivable basis;

(b) deferring the claim for certain deductions from taxable profit;

(c) selling, and perhaps leasing back, assets that have appreciated but for which the tax base has not been adjusted to reflect such appreciation; and

(d) selling an asset that generates non-taxable income (such as, in some jurisdictions, a government bond) in order to purchase another investment that generates taxable income.

Where tax planning opportunities advance taxable profit from a later period to an earlier period, the utilisation of a tax loss or tax credit carryforward still depends on the existence of future taxable profit from sources other than future originating temporary differences. An action that results in reversal of existing deductible temporary differences without creating or increasing taxable profit in the future is not a tax planning opportunity.

34 A deferred tax asset shall be recognised for the carryforward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit of the appropriate character (for example, ordinary income or capital gain) will be available against which the unused tax losses and unused tax credits can be utilised.

Appendix B - Basis for Conclusions on proposed amendment to IAS 12 *Income Taxes*

The Basis for Conclusions accompanies, but is not part of, the proposed amendments.

Recognising deferred tax assets for unrealised losses for available-for-sale debt securities

BC1 The Board was asked to provide guidance on how an entity determines, in accordance with IAS 12 *Income Taxes*, whether to recognise a deferred tax asset relating to unrealised losses on available-for-sale debt securities (AFS debt securities) in a situation when an entity;

(a) has a deductible temporary difference relating to unrealised loss on AFS debt securities that are measured at fair value,

(b) has the ability and intent to hold the AFS debt securities to receive the future contractual cash flows until the loss reverses (which may be at maturity of the AFS debt securities); and

(c) has insufficient taxable temporary differences and no other probable taxable profits against which the deductible temporary difference relating to the AFS debt securities can be utilised.

BC2 The Board noted that paragraph 24 of IAS 12 requires a deferred tax asset be recognised only to the extent of probable future taxable profit against which the deductible temporary difference can be utilised. The deductible temporary difference is utilised when the deductible temporary difference reverses and offset against taxable income in accordance with tax law. Tax law generally offsets a deduction against taxable income on an entity basis without segregating each temporary difference. In such a case, the assessment of a deferred tax asset should be made on a combined basis. In some jurisdictions, tax law specifically distinguishes specific types of income (eg capital gains) from other taxable profit and permit specific types of loss to be offset only against the same types of income. In such a case, the assessment of a deferred tax asset should also be made on a combined basis with separation of each type of taxable income. The Board proposes to amend paragraph 24 of IAS 12 to clarify this. The Board also proposes to amend paragraph 34 of IAS 12 to clarify the similar issue involving unused tax losses and unused tax credits.

BC3 Paragraphs 28 and 29 of IAS 12 provide three types of source of taxable profits against which deductible temporary differences relating to the same taxation authority and the same taxable entity can be utilised. They are;

(a) future reversal of existing taxable temporary differences;

(b) future taxable profits; and

(c) tax planning opportunities.

BC4 The Board noted that future taxable income against which a deductible temporary difference can be utilised is the amount before a deduction as a result of reversal of the deductible temporary difference. The Board noted that the deduction would be double counted if the reversal of the deductible temporary difference was not excluded. The Board proposes to add words in paragraphs 29 and 30 of IAS 12 to clarify this.