STAFF PAPER

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Project	**Annual Improvements to IFRSs—2010-2012 Cycle (ED/2012/1) comment letter analysis—project options**		
Paper topic	IAS 12 *Income Taxes*—Recognition of deferred tax assets for unrealised losses		
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Introduction

1. The Exposure Draft *Annual Improvements to IFRSs 2010-2012 Cycle* published in May 2012 (ED), for which the comment period ended 5 September 2012, includes three proposals to clarify the requirements of IAS 12 *Income Taxes*, namely:

   (a) an entity assesses whether to recognise the tax effect of a deductible temporary difference as a deferred tax asset in combination with other deferred tax assets. If tax law restricts the utilisation of tax losses so that an entity can only deduct tax losses against income of a specific type (eg if it can deduct capital losses only against capital gains), the entity must still assess a deferred tax asset in combination with other deferred tax assets, but only with deferred tax assets of the appropriate type;

   (b) taxable profit against which an entity assesses a deferred tax asset for recognition is the amount before any reversal of deductible temporary differences; and

   (c) an action that results only in the reversal of existing deductible temporary differences is not a tax planning opportunity. To qualify as a tax planning opportunity, the action needs to create or increase taxable profit.

2. The IASB proposed the amendment to IAS 12 to resolve diversity in accounting for deferred tax assets for unrealised losses on debt instruments.

3. The IFRS Interpretations Committee ("the Interpretations Committee") discussed a comment letter analysis prepared by the staff for the proposals at its meeting in November 2012.

4. As a result, the Interpretations Committee recommends continuing with the proposed amendment to IAS 12 to clarify the accounting for deferred tax assets for unrealised losses on debt instruments.

5. The Interpretations Committee noted, however, that clarifying the accounting for deferred tax assets for unrealised losses on debt instruments requires addressing two additional issues:

   (a) whether an unrealised loss on a debt instrument measured at fair value gives rise to a deductible temporary difference when the holder expects to recover the carrying amount of the asset by holding it to maturity and collecting all the contractual cash flows; and

   (b) whether an entity can assume recovery of an asset for more than its carrying amount when estimating probable future taxable profits against which deductible temporary differences can be utilised (see paragraph 24 of IAS 12).

6. The Interpretations Committee recommends that these two issues should be resolved.

7. However, it was not clear at this stage whether resolving these two issues could be achieved within the constraints of the Annual Improvements process, or whether this work needs to be undertaken as a narrow-scope amendment to IAS 12.

8. Consequently, the Interpretations Committee decided to consult the IASB on the most appropriate path forward before commencing work on these two matters.

Purpose of the paper

9. The purpose of this paper is to:

   (a) inform the IASB about the results from the Interpretations Committee's comment letter analysis;

   (b) inform the IASB of discussions by the US-based Financial Accounting Standards Board (FASB) on this issue, including the FASB's tentative decision;

   (c) ask the IASB for its agreement for the Interpretations Committee to proceed with its work on this issue 'Recognition of deferred tax assets for unrealised losses'; and

   (d) ask the IASB for its advice on the most efficient manner to address the technical issues identified by the Interpretations Committee (eg a separate narrow-scope amendment to IAS 12 or inclusion in annual improvements) and the required due process steps that would arise from this advice.

Structure of the paper

10. This agenda paper:

   (a) provides background information on the issue;

   (b) summarises the results from the Interpretations Committee's comment letter analysis;

   (c) explains the reasons for asking the IASB for advice on the next steps;

   (d) summarises recent discussions by the FASB and its tentative decision; and

   (e) gives a staff recommendation.

Background information

11. In March 2010, the Interpretations Committee was asked to provide guidance on how an entity determines, in accordance with IAS 12, whether to recognise a deferred tax asset when the entity:

    (a) has deductible temporary differences relating to unrealised losses on debt instruments that are classified as available-for-sale financial assets in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* and measured at fair value;

    (b) has the ability and intention to hold the instruments until the loss reverses (which may be at their maturity); and

    (c) has insufficient taxable temporary differences and no other probable taxable profits against which the entity can utilise those deductible temporary differences.

12. The Interpretations Committee reported to the IASB that practice differed because of divergent views on the following questions:

    (a) Does an entity assess whether a deferred tax asset is recognised for each deductible temporary difference separately, or in combination with other deductible temporary differences?

    (b) When an entity assesses whether it can utilise a deductible temporary difference against probable future taxable profits, do those probable future taxable profits include the effects of reversing deductible temporary differences?

    (c) If an entity has the ability and intention to hold an available-for-sale debt instrument until an unrealised loss reverses, does that create a source of taxable profits; for example, because it is a tax planning opportunity or akin to a tax planning opportunity?

13. In order to resolve the significant diversity in practice, the IASB proposed the clarifications presented in paragraph 1 of this paper in its ED.

14. The proposed amendment to IAS 12 that was presented in the ED is reproduced in Appendix A to this paper.

Results from the Interpretations Committee's comment letter analysis

15. The Interpretations Committee concluded from its analysis of the comment letters on the ED that clarifying the accounting for deferred tax assets for unrealised losses on debt instruments requires the clarification of the following issues:

    (a) Does an unrealised loss on a debt instrument measured at fair value give rise to a deductible temporary difference when the holder expects to recover the carrying amount of the asset by holding it to maturity and collecting all the contractual cash flows?

    (b) Which adjustments need to be made to taxable profit as defined in paragraph 5 of IAS 12 for assessing the recognition of deferred tax assets?

    (c) Can an entity assume recovery of an asset for more than its carrying amount when estimating probable future taxable profits against which deductible temporary differences can be utilised?

    (d) Are deductible temporary differences resulting from unrealised losses on available-for-sale debt instruments assessed separately from other deductible temporary differences for utilisation, or in combination with other deductible temporary differences of the entity?

16. For further details on the comment letter analysis discussed by the Interpretations Committee, refer to Agenda Paper 10E presented at the November 2012 Interpretations Committee meeting.[1]

Does an unrealised loss on a debt instrument measured at fair value give rise to a deductible temporary difference when the holder expects to recover the carrying amount of the asset by holding it to maturity and collecting all the contractual cash flows?

Description of the issue

17. Paragraph 5(b) of IAS 12 defines *deductible temporary differences* (DTD) as temporary differences that will result in amounts that are deductible in

[1] http://www.ifrs.org/Meetings/Pages/IFRSInterNov012.aspx

determining taxable profit (tax loss) of future periods when the carrying amount of the asset or the liability is recovered or settled.

18. The Interpretations Committee noted divergent views from the comment letters on when a temporary difference from an unrealised loss on an available-for-sale debt instrument will result in an amount that is deductible in determining taxable profit (tax loss) of a future period when the carrying amount of the asset is recovered.

19. Respondents consistently think that realising the loss, eg by selling the debt instrument for its carrying amount, will result in such a deductible amount because the entity can offset the tax loss from the sale of the debt instrument against taxable income from other sources. Consequently, there is a deductible temporary difference when the entity expects to recover the carrying amount of the available-for-sale debt instrument by realising the loss.

20. The Interpretations Committee noted divergent views from the comment letters on whether a temporary difference from an unrealised loss on an available-for-sale debt instrument will result in such deductible amounts, if the unrealised loss reverses because the entity expects to recover the carrying amount of the debt instrument by holding it to maturity and collecting all the contractual cash flows.

21. These views can be summarised as follows:

    (a) **View 1 (DTD also when holding):** proponents of this view think that there is also a deductible temporary difference from the unrealised loss on an available-for-sale debt instrument, if the unrealised loss reverses because the entity expects to recover the carrying amount of the debt instrument by holding it to maturity and collecting all the contractual cash flows. The difference between the carrying amount of the available-for-sale debt instrument and its higher tax base gives rise to a deductible temporary difference, because the repayment of the principal is viewed as a taxable economic benefit and the tax base of the available-sale debt instrument can be offset against this taxable economic benefit. Consequently, the temporary difference will result in an amount that is deductible against the receipt of the principal on the available-for-sale debt instrument in determining taxable profit (or tax loss) of future periods when the carrying amount of the asset is recovered (see the definition of 'deductible temporary differences' in paragraph 5 of IAS 12).

(b) **View 2 (DTD only on sale):** proponents of this view think that there is no deductible temporary difference from the unrealised loss on an available-for-sale debt instrument, if the unrealised loss reverses because the entity expects to recover the carrying amount of the debt instrument by holding it to maturity and collecting all the contractual cash flows. The difference between the carrying amount of the available-for-sale debt instrument and its higher tax base does not give rise to a deductible temporary difference, because the repayment of the principal is not viewed as taxable economic benefit and the tax base of the available-sale debt instrument is therefore not offset against any taxable economic benefit. Consequently, the temporary difference will not result in an amount that is deductible against the receipt of the principal on the available-for-sale debt instrument in determining taxable profit (or tax loss) of future periods when the carrying amount of the asset is recovered (see the definition of 'deductible temporary differences' in paragraph 5 of IAS 12). The reversal of the unrealised loss is a non-tax event.

Illustrative example

22. The divergent views are illustrated by the following example:

Fact pattern:

Entity A invests at the beginning of Year 1 CU1,000[2] in an available-for-sale debt instrument with a nominal value of CU1,000 payable on maturity in 5 years.

Interest is paid at the end of each year at a rate of 2 per cent, taxable when received. The market interest rate is 5 per cent at the end of Year 2, which results in a fair value of the debt instrument at the end of Year 2 of CU918. The shortfall is due solely to the difference between market interest rate and the nominal interest rate of the debt instrument, ie Entity A does not consider the debt instrument to be impaired.

[2] In this staff paper, currency amounts are denominated in 'currency units' (CU).

> Management's intention is to hold the available-for-sale debt instrument until maturity and expects to collect the contractual cash flows.
>
> Tax law does not allow Entity A to deduct the loss until it is realised, ie by selling the debt instrument or by failure of the issuer to repay the principal.
>
> Entity A has no other transactions in Years 1 to 5 than the ones related to the available-for-sale debt instrument.

23. Accordingly, Entity A records the following in- and outflows of economic benefits in Years 1 to 5:

Period	Transaction	CU
Year 1	Investment in available-for-sale debt instrument at the beginning of Year 1	-1,000
Year 1	Interest income received at the end of Year 1	20
Year 2	Interest income received at the end of Year 2	20
Year 3	Interest income received at the end of Year 3	20
Year 4	Interest income received at the end of Year 4	20
Year 5	Interest income and repayment of principal received at the end of Year 5	1,020

24. This would have the following tax effect in Year 5:

	CU
Economic benefit that will flow to Entity A in Year 5 (repayment of principal + interest for Year 5)	1,020
Less tax base	-1,000
Future taxable profit in Year 5	20

25. In this case, proponents of View 1 (DTD also when holding) and View 2 (DTD only on sale) come to different conclusions:

    (a) Proponents of View 1 (DTD also when holding) conclude that there is a deductible temporary difference of CU88 (carrying amount (fair value) CU912 less tax base of CU1,000) because there is a tax deduction of CU1,000 and, if this is Entity A's only transaction in Year 5, it receives taxable economic benefits of CU1,020. Because of the tax deduction of CU1,000, however, taxable profit is only CU20.

(b) Proponents of View 2 (DTD only on sale) instead consider the repayment of the principal to be a non-tax event, because there is no reduction in future tax payments/on future taxable profits from recovering the principal. Accordingly, they do not think that there is a deductible temporary difference at the end of Year 2.

Proposal in the ED

26. The issue of whether a deductible temporary difference results from the unrealised loss on an available-for-sale debt instrument, if the entity expects to recover the carrying amount of the debt instrument by holding it to maturity and collecting all the contractual cash flows, was not explicitly addressed in the ED.

27. The example following draft paragraph 30A of IAS 12 in the ED instead merely assumed that the unrealised loss gives rise to a deductible temporary difference.

Staff analysis and discussion at the Interpretations Committee meeting

28. We agree with View 1 (DTD also when holding) because we think that it better aligns with the concept of IAS 12. In determining taxable profits (tax losses), the entity:

(a) deducts the tax base of an asset

(b) against any taxable economic benefits that flow to the entity

(c) when it recovers the carrying amount of the asset (see paragraphs 7 and 16 of IAS 12).

29. The fact that the repayment of the principal of the available-for-sale debt instrument in the example above does not reduce or increase tax payment results from the fact that the tax base equals the economic benefits from the repayment of the principal. This is because tax law does not aim to raise taxes on the repayment of the principal and therefore gives a tax deduction that equals the repayment of the principal on its repayment.

30. This should not, however, in our opinion be a reason for concluding that the reversal of the temporary difference will not result in amounts that are deductible

in determining taxable profits (tax loss) of future periods when the carrying amount of the asset or the liability is recovered.

31. The Interpretations Committee did not take a decision on this issue. However, several Interpretations Committee members supported the staff's view.

Which adjustments need to be made to taxable profit as defined in paragraph 5 of IAS 12 for assessing the recognition of deferred tax assets?

Description of the issue

32. Paragraph 24 of IAS 12 requires the assessment of deductible temporary differences against probable future *taxable profits* for utilisation when assessing the recognition of deferred tax assets.

33. Paragraph 5 of IAS 12 defines *taxable profits* as the profit for a period, determined in accordance with the rules established by the taxation authorities, *upon which income taxes are payable*.

34. Consequently, assessing the recognition of deferred tax assets on the basis of taxable profits might result in double-counting, because the *amount upon which income taxes are payable* might include tax deductions resulting from the reversal of deductible temporary differences.

35. The question is therefore what adjustments need to be made to taxable profit as defined in paragraph 5 of IAS 12 for assessing the utilisation of deductible temporary differences/the recognition of deferred tax assets.

Illustrative example

36. This may be illustrated by Example 1 following paragraph 8 of IAS 12.

37. In that example, current liabilities include accrued expenses with a carrying amount of CU100. The related expense will be deducted for tax purposes in a future period on a cash basis. It is concluded in the example that the tax base of the accrued expenses is nil.

38. In order to recognise a deferred tax asset, the entity needs to assess whether it expects sufficient probable future taxable profits against which the deductible temporary difference can be utilised in order to realise the economic benefit of the deferred tax asset.

39. Probable future taxable profit will include estimates of future taxable profit arising from the various activities of the entity.

40. However, the tax deduction resulting from the reversal of the deductible temporary difference related to the accrued expenses should be excluded from the estimate of the probable future taxable profit of the period when the deductible temporary difference reverses, ie excluded from the estimate of the amount upon which the entity expects to pay taxes.

41. This is because without excluding the tax deduction resulting from the reversal of the deductible temporary difference from taxable profit (ie adding this tax deduction back to taxable profit), the entity would need taxable income of CU200 to offset a tax deduction of CU100, ie the deductible temporary difference would end up being double-counted.

Divergent views and interpretations

42. While we noted that there is general agreement among respondents that taxable profit, upon which income taxes are payable, cannot be the taxable profit against which deferred tax assets are assessed for recognition because of the double-counting issue, we also noted that there is uncertainty among respondents on which adjustments need to be made to taxable profit as defined in paragraph 5 of IAS 12 for assessing the recognition of deferred tax assets.

43. This uncertainty amongst respondents includes whether taxable profit as defined in paragraph 5 of IAS 12 has to be increased for the gain resulting from the reversal of the unrealised loss on the available-for-sale debt instrument when assessing whether the deferred tax asset for the unrealised loss on this debt instrument can be recognised.

44. The uncertainty about which adjustments need to be made to taxable profit for assessing the recognition of deferred tax assets resulted in divergent approaches:

    (a) In one approach, amounts resulting from the reversal of deductible temporary differences are always (mechanically) added back to taxable profit.

    (b) Other approaches instead add such amounts back to taxable profit only if further specific requirements are met, eg if the amount resulting from the reversal of deductible temporary differences gives rise to an actual tax deduction that will result in lower tax payments.

45. Other approaches focus on whether the tax deduction relates to an adjustment in the reconciliation between accounting profit before tax and taxable profit.

46. Views differ, however, on the inferences that should be drawn from the fact that a tax deduction relates to an adjustment in the reconciliation between accounting profit before tax and taxable profit. While some see this as requiring the adding back of all tax deductions made in the reconciliation between accounting profit before tax and taxable profits to taxable profits, others would only add back such adjustments to taxable profits that represent timing differences.

Proposal in the ED

47. In order to address the double-counting issue, the ED proposed to clarify in draft paragraph 29(a)(i) of IAS 12 that **all** amounts resulting from the reversal of deductible temporary differences are added back to taxable profit for assessing the recognition of deferred tax assets.

48. Deductible temporary differences represent future tax deductions, and to avoid double-counting, all amounts resulting from the reversal of such temporary differences must be added back to taxable profits for assessing the recognition of deferred tax assets on a collective basis.

49. Tax deductions resulting from the reversal of deductible temporary differences are added back to taxable profit (tax loss) because taxable profit is taxable income less tax deductions. The ED proposed an example illustrating that issue.

Staff analysis and discussion at the Interpretations Committee meeting

50. We recommended to the Interpretations Committee, on the basis of the analysis of the comment letters, that the conclusion that all tax deductions resulting from the reversal of deductible temporary should be added back to taxable profit when assessing deferred tax assets for recognition should not be changed.

51. The Interpretations Committee did not take a decision on that issue, although there was support for our recommendation.

52. The Interpretations Committee noted from the comment letter analysis, however, that future taxable profit before deducting the amounts resulting from the reversal of deductible temporary differences needs to be further clarified beyond the clarifications in the ED.

53. In addition, we want to highlight the interrelationship of this issue with the previous issue (which concerned the existence of a deductible temporary difference when the holder expects to recover the carrying amount of the debt instrument measured at fair value by holding it to maturity and collecting all the contractual cash flows).

54. Only tax deductions resulting from the reversal of deductible temporary differences are added back to taxable profit for assessing the recognition of deferred tax assets.

55. Consequently, only entities applying the view that there is a deductible temporary difference, if the entity expects to recover the carrying amount of the debt instrument by holding it to maturity and collecting all the contractual cash flows, need to adjust taxable profit for assessing whether the related deferred tax asset can be recognised.

56. For entities applying the contrary view instead, the question does not arise. Without a deductible temporary difference there is no deferred tax asset that might be recognised.

Can an entity assume recovery of an asset for more than its carrying amount when estimating probable future taxable profits against which deductible temporary differences can be utilised?

Description of the issue

57. According to the Objective of IAS 12 and paragraphs 16 and 51 of IAS 12, accounting for deferred tax assets and deferred tax liabilities is based on the inherent assumption that assets are recovered for their carrying amount.

58. The Interpretations Committee noted significant diversity in practice on whether this inherent assumption is only relevant for determining taxable and deductible temporary differences, or also for estimating probable future taxable profits

against which deductible temporary differences can be utilised (see paragraph 24 of IAS 12).

Illustrative example

59. This may be illustrated by the example in paragraphs 22 and 23 of this paper.

60. Entity A could only recognise the deferred tax asset for the unrealised loss of the available-for-sale debt instrument if it could assume that it will recover this asset for CU1,000, ie for more than its carrying amount. This is because no other source of taxable profit is available in the fact pattern given in the example.

61. If Entity A instead had to assume that it would recover the available-for-sale debt instrument only for its carrying amount of CU918, Entity A's future taxable profit before deducting amounts resulting from the reversal of the deductible temporary difference in Year 5 would not be sufficient to offset the entire tax base and so the deferred tax asset could not be recognised.

Proposal in the ED

62. The ED did not explicitly address this issue. However, the example following draft paragraph 30A of IAS 12 in the ED was based on the assumption that Entity A would recover the debt instrument only for its carrying amount of CU80. Consequently, Entity A could not recognise the deferred tax asset related to the debt instrument because it also lacked probable future taxable profits of the appropriate type from other sources.

Staff analysis and discussion at the Interpretations Committee meeting

63. Analysing the issue, and taking into consideration the comments received, we recommended to the Interpretations Committee that an entity should assume that it will recover an asset for more than the carrying amount when estimating future taxable profits against which deductible temporary differences can be utilised, provided that the recovery for more than the carrying amount is probable.

64. Consequently, the inherent assumption that assets are recovered for their carrying amount determines the amount of temporary differences but not the probable future taxable profits against which deductible temporary differences can be utilised.

65. The Interpretations Committee did not take a decision on that issue, however, several member of the Interpretations Committee supported our recommendation.

Are deductible temporary differences resulting from unrealised losses on available-for-sale debt instruments assessed separately from other deductible temporary differences for utilisation, or in combination with other deductible temporary differences of the entity?

Description of the issue

66. Deferred tax assets are only recognised if the reversal of deductible temporary differences will result in reductions of future tax payments (see paragraph 27 of IAS 12).

67. Consequently, deferred tax assets are not recognised if the reversal of the deductible temporary difference only creates or increases a tax loss.

68. Whether the reversal of deductible temporary differences reduces future tax payments, or only creates or increases tax losses, depends on grouping; ie what (type(s) of) deductible temporary differences are assessed for utilisation against what (type(s) of) taxable gains and losses/taxable income.

69. The Interpretations Committee noted divergent views on whether deductible temporary differences resulting from unrealised losses on available-for-sale debt instruments are assessed separately from other deductible temporary differences for utilisation, or in combination other deductible temporary differences of the entity.

70. Some assess deductible temporary differences related to unrealised losses on available-for-sale debt instruments separately from other deferred tax assets for utilisation because:

    (a) the deductible temporary difference relating to the unrealised loss 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 income of different character (eg ordinary income or capital gain) separately when assessing the future realisation of deductible temporary differences.

71. Others assess such deductible temporary differences together with all other deductible temporary differences if this aligns with tax law, because paragraphs 24 and 27 of IAS 12 require the assessment of the utilisation of deductible temporary differences on the basis of tax law.

Proposal in the ED

72. The ED proposed to clarify that the utilisation of deductible temporary differences has to be assessed only on the basis of tax law, ie the grouping is determined by tax law and only by tax law.

73. Consequently, an entity assesses, in general, whether to recognise the tax effect of a deductible temporary difference as a deferred tax asset in combination with all the other deferred tax assets of the entity. If tax law restricts the utilisation of tax losses so that an entity can only deduct tax losses against income of a specific type (eg if it can deduct capital losses only against capital gains), the entity must still assess a deferred tax asset in combination with other deferred tax assets, but only with deferred tax assets of the appropriate type.

Staff analysis and discussion at the Interpretations Committee meeting

74. The Interpretations Committee noted from the comment letter analysis that this proposed amendment was generally supported.

Reason for asking the IASB for a recommendation on the next steps

75. There was strong support for the analysis that the staff presented in paragraphs 17-74 of this paper from several members of the Interpretations Committee and the Interpretations Committee decided to recommend to the IASB that IAS 12 should be amended to clarify the accounting for deferred tax assets for unrealised losses.

76. On the basis of our analysis we recommended to the Interpretations Committee that the issue should be addressed in a separate project to amend IAS 12, because, as far as we can ascertain, the issue of whether an entity can assume that it will recover an asset for more than its carrying amount when estimating probable future taxable profits:

(a) is not addressed in current IAS 12; or

(b) has not been discussed by the IASC or its Steering Committee in developing IAS 12 (revised 1996).

77. Consequently, we noted that the issue is about understanding what the principles are in IAS 12, which arguably moves the amendment beyond an annual improvement to a project that is not merely clarifying or correcting in nature albeit still narrow in scope. This led us to recommend to the Interpretations Committee that the issue should be addressed in a separate project to amend IAS 12.

78. Several members of the Interpretations Committee thought instead that the issue still qualifies for annual improvements and should be finalised as such.

79. Further discussions showed that it was not clear at this stage of the of the project whether guidance on the recognition of deferred tax assets can be given within the constraints of the Annual Improvements process, or whether this work would need to be undertaken as a narrow-scope amendment to IAS 12.

80. In particular, the analysis presented above showed that two issues need to be resolved to ensure a consistent accounting for deferred tax assets for unrealised losses on debt instruments that have not been addressed explicitly in the ED, namely:

(a) whether an unrealised loss on a debt instrument measured at fair value gives rise to a deductible temporary difference when the holder expects to recover the carrying amount of the asset by holding it to maturity and collecting all the contractual cash flows; and

(b) whether an entity can assume recovery of an asset for more than its carrying amount when estimating probable future taxable profits against which deductible temporary differences can be utilised.

81. Consequently, the Interpretations Committee decided to consult the IASB on the most appropriate path forward before commencing further work.

FASB discussion

Summary of FASB discussion and its tentative decision

82. At its meeting on 3 October 2012 the FASB discussed an issue related to our proposed annual improvement, within the context of US GAAP, and as part of their project on accounting for financial instruments: classification and measurement.

83. The FASB discussed whether the need for a valuation allowance related to deferred tax assets (DTAs) arising from unrealised losses recognised in other comprehensive income on debt instruments classified and measured at fair value through other comprehensive income (FVOCI debt instruments) is evaluated:

    (a) separately from the entity's other deferred tax assets; or

    (b) in combination with an entity's other deferred tax assets.[3]

84. The FASB discussed the issue within the context of FVOCI debt instruments for which the fair value is below its cost basis, but the entity holding the debt instrument does not expect any loss of principal or interest. The entity expects to collect all the contractual cash flows if it holds the FVOCI debt instrument until maturity and has the ability and intention to hold the debt instrument until the loss has reversed, which may be until maturity.

85. The FASB tentatively decided that an entity should evaluate the need for a valuation allowance on deferred tax assets related to debt instruments classified and measured at FVOCI separately from its evaluation of other deferred tax assets[4].

86. The FASB proposes that separate assessment should only apply to deferred tax assets related to losses on FVOCI debt instruments that have been recognised in

[3] See Board Meeting Handout for Board meeting on 3 October 2012, issue *Assessment of the Need for a Valuation Allowance against Deferred Tax Assets Related to Debt Instruments Classified and Measured at Fair Value through Other Comprehensive Income (FVOCI)*: http://www.fasb.org/cs/ContentServer?site=FASB&c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176160397639

[4]http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176160473368

OCI. Deferred tax assets that relate to losses that have been recognised in net income are assessed in combination with other deferred tax assets.

87. The effect of the separate assessment of the deferred tax assets related to FVOCI debt instruments is that a valuation allowance would not be necessary for the deferred tax assets related to unrealised losses on debt instruments recognised in OCI as long as the entity expects to receive all the contractual cash flows. This would apply even when significant negative evidence, such as recent cumulative losses, exists about whether other deferred tax assets could be realised by the entity.

88. Under the FASB proposal, a valuation allowance would not be necessary as long as the entity expects to receive all the contractual cash flows, because a DTA related to unrealised losses on FVOCI debt instruments is unique and results from the interaction of Topic 740 *Income Taxes* in the FASB *Accounting Standards Codification*® and Topic 320 *Investments—Debt and Equity Securities*. Consequently, the FASB thinks that it is appropriate to acknowledge this special case of interaction and treat the unrealised losses on FVOCI debt instruments separately by assessing their related DTAs separately from other DTAs.

89. Consequently, the effect of the separate assessment approach is that the deferred tax assets related to the FVOCI debt instruments are not reduced by a valuation allowance even if the effect holding the FVOCI debt instrument would be to simply reduce future tax losses, ie they do not create taxable income.

IASB staff analysis

90. We think that the FASB's proposed approach presented in paragraphs 82-89 of this paper is different from the requirements of IAS 12 for the following reasons:

(a) IAS 12 requires a combined assessment of all deferred tax assets unless tax law introduces limitations for utilising tax deductions. Draft paragraph 27A in the Exposure Draft *Annual Improvements to IFRSs 2010-2012 Cycle* is a proposed clarification of the principles in IAS 12 and not a proposed change to them.

(b) IAS 12 does not allow the recognition of deferred tax assets for deductible temporary differences that will not reduce future taxable profits on their reversal (see paragraph 24 of IAS 12).

91. We think the conclusion in paragraph 90(b) of this paper is supported by the following requirements in IAS 12:

(a) Deductible temporary differences are amounts that will result in tax deductions in determining taxable profit (tax loss) of future periods (see the definition of a deductible temporary difference in paragraph 5(b) of IAS 12.

(b) Deductible temporary differences are utilised by offsetting the tax deductions against taxable profits (see paragraph 27 of IAS 12).

(c) Taxable profits are amounts solely determined by tax law (see the definition of taxable profit (tax loss) in paragraph 5 of IAS 12).

Finally, the conclusion is also supported by the fact that we do not see any exception in IAS 12 from the requirements in paragraphs 91(a)-91(c) of this paper.

92. We also note that if the approach of separate assessment proposed by the FASB were to be applied under IAS 12, deferred tax assets related to unrealised losses on FVOCI debt instruments recognised in OCI would always be recognised, even if the consequence of holding the FVOCI debt instruments would be to simply reduce future tax losses, rather than to create taxable profits.

93. Furthermore, if the reversal of the deductible temporary difference does not reduce future tax payments, we do not see what future economic benefit is embodied in the deferred tax asset.

No involvement of the Interpretations Committee so far

94. We want to highlight that the tentative decision of the FASB and the related discussion have not been considered by the Interpretations Committee so far.

95. However, we think that it should be taken into account in the IASB's discussions before the IASB advises the Interpretations Committee on the most appropriate path forward.

Staff recommendation

96. We think that there are three possible paths forward to resolve diversity in accounting for deferred tax assets for unrealised losses on debt instruments:

    (a) give guidance in a separate narrow-scope project to amend IAS 12;

    (b) clarify the accounting for deferred tax assets for unrealised losses in this annual improvements cycle (2010-2012 Cycle); or

    (c) clarify the accounting for deferred tax assets for unrealised in a future annual improvements cycle (ie the 2012-2014 Cycle).

97. A separate project to amend IAS 12 is the only path forward, if the IASB thinks that resolving one or both of the following issues does not qualify for inclusion in annual improvements:

    (a) whether an unrealised loss on a debt instrument measured at fair value gives rise to a deductible temporary difference when the holder expects to recover the carrying amount of the asset by holding it to maturity and collecting all the contractual cash flows; and

    (b) whether an entity can assume recovery of an asset for more than its carrying amount when estimating probable future taxable profits against which deductible temporary differences can be utilised.

98. A separate project to amend IAS 12 would be the only path forward, if the IASB were to follow the FASB approach, of requiring a separate assessment of deferred tax assets arising from unrealised losses recognised in other comprehensive income on FVOCI debt instruments, were to be introduced into IAS 12. This is because we think, for the reasons given in paragraph 90 of this paper, that the FASB approach would amend principles in IAS 12 by introducing a rule-making exception.

99. Otherwise, we think that the guidance on accounting for unrealised losses on debt instruments could be introduced by any of the three paths listed in paragraph 96 of this paper.

100. Resolving the issue as part of this annual improvements cycle (2010-2012 Cycle) provides the benefit of giving guidance on a timely basis after analysing various comments received on the ED.

101. Resolving the issue as part of a future annual improvements cycle (eg the 2012-2014 Cycle) provides the benefit that a revised proposal is exposed for comments.

102. A separate project to amend IAS 12 also provides this benefit. In addition, it responds to the concern raised in several comment letters (eg EFRAG, Mazars) on the ED that the proposed amendment to IAS 12 is broader than an annual improvement, considering the way that it was drafted. The proposed amendment is not explicitly limited to the specific fact pattern of unrealised losses on debt instruments. Instead, the proposed amendment aims to clarify the requirements in IAS 12 in a more general way and therefore has a broader applicability.

103. Summarising the discussion, we recommend that the most appropriate path forward to clarify the accounting for deferred tax assets for unrealised losses on debt instruments is a separate narrow-scope project to amend IAS 12. This is because:

    (a) the issue of whether an entity can assume that it will recover an asset for more than its carrying when estimating probable future taxable profits should be addressed in a separate narrow-scope project for the reasons given in paragraphs 76 and 77 of this paper; and

    (b) a project that goes beyond clarifications and corrections (ie a project with a broader scope than annual improvements) also allows for discussing the pros and cons of the FASB proposals. In particular, such a project would allow a discussion of what future economic benefit embodied in a deferred tax asset related to losses on FVOCI debt instruments is, if the reversal of the deductible temporary difference does not reduce future tax payments.

Questions to the IASB

1. Does the IASB agree that the issue ‘Recognition of deferred tax assets for unrealised losses’ should be addressed in a separate narrow-scope project to amend IAS 12?

2. What other comments does the IASB have on the staff analysis and the conclusions of the Interpretations Committee?

Appendix A—ED

A1. The proposed amendment to IAS 12 that was presented in the ED is reproduced below:

Proposed amendment to IAS 12 *Income Taxes*

The Board proposes to amend IAS 12 by amending paragraphs 29 and 30, adding paragraphs 27A, 30A and 98C and adding examples after paragraphs 29 and 30A.

The proposed amendment is marked up in the text of IAS 12 (new text is underlined and deleted text is struck through). Paragraphs 24 and 27 are not proposed for amendment but are included here for ease of reference.

The following Basis for Conclusions accompanies, but is not part of, the proposed amendment. It sets out the reasons why the Board proposes the amendment. If the amendment is approved, this basis will be included in the Basis for Conclusions on IAS 12 *Income Taxes*, which is not part of the IFRS.

Deductible temporary differences

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).**

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

...

27 The reversal of deductible temporary differences results in deductions in determining taxable profits of future periods. However, economic benefits in the form of reductions in tax payments will flow to the entity only if it earns sufficient taxable profits against which the deductions can be offset. Therefore, an entity recognises deferred tax assets only when it is probable that taxable profits will be available against which the deductible temporary differences can be utilised.

27A When an entity assesses whether taxable profits will be available against which it can utilise a deductible temporary difference, the entity considers whether tax law restricts the sources of taxable profit against which the entity may make deductions on the reversal of that deductible temporary difference. If tax law imposes no such restrictions, an entity assesses a deductible temporary difference in combination with all its other deductible temporary differences. However, if tax law restricts the utilisation of losses to deduction against income of a specified type, a deductible temporary difference is assessed in combination only with other deductible temporary differences of the appropriate type.

...

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 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:

(i) compares the deductible temporary differences with those future taxable profits before deducting the amounts resulting from the reversal of those deductible temporary differences. This comparison shows the extent to which the future taxable profits are sufficient that the entity will be able to deduct the amounts resulting from the reversal of those deductible temporary differences; and

(ii) 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.

Example
Entity A has an asset with a carrying amount of 100 and a tax base of 170. Entity A has no other deductible temporary differences, no unused tax losses and no unused tax credits. Tax law offsets all deductions against taxable income from all sources. Entity A concludes that it is probable that, after deducting the amount resulting from the reversal of the deductible temporary difference, it will file a tax return showing a taxable profit of nil and tax losses of nil in the period in which it recovers the carrying amount of the asset. *At the end of the reporting period a deductible temporary difference of 70 (170 less 100) is associated with the asset and needs to be assessed for recoverability. Entity A recognises a deferred tax asset because it is probable that it will have taxable profit of 70 relating to the same taxation authority and the same taxable entity in the same period as the reversal of the deductible temporary difference of 70. For assessing the recognition of the deferred tax asset, Entity A compares the deductible temporary difference of 70 with its probable future taxable profit of 70 (nil plus 70) before deducting the amount resulting from the reversal of the deductible temporary difference of 70.*

30 Tax planning opportunities are actions that the entity would take in order to create or increase taxable profit ~~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.

30A An action does not qualify as a tax planning opportunity if the action does not create or increase taxable profit. Consequently, if an action results only in the reversal of existing deductible temporary differences, that action is not a tax planning opportunity because that reversal does not create or increase taxable profit.

Example

Entity A has only two deductible temporary differences and no taxable temporary differences:

(a) Entity A purchased a debt instrument for 100 and classified it as a financial asset at fair value through profit or loss in accordance with IFRS 9 *Financial Instruments*. At the end of the reporting period, the debt instrument has a fair value of 80. Consequently, Entity A recognises an unrealised loss of 20 in profit or loss. It expects to receive all future contractual cash flows and hence expects that the loss of 20 will reverse (no later than by maturity of the debt instrument). Tax law does not allow unrealised losses on debt instruments to be deducted from taxable profit, ie the tax base remains 100 until the loss is considered realised for tax purposes. Entity A does not generally plan to hold debt instruments until their maturity but may choose to do so, for example, to avoid realising a loss.

(b) Entity A also has an item of property, plant and equipment with a carrying amount of 50 and a tax base of 80.

Tax law classifies gains and losses on debt instruments as capital gains and losses, and capital losses can only be offset against capital gains. Tax law classifies gains and losses on property, plant and equipment as ordinary gains and losses, and ordinary losses can only be offset against ordinary gains or losses.

Entity A considers it probable that its taxable profits relating to ordinary gains and losses will be more than 1,000 in each of the periods over which the carrying amount of the item of property, plant and equipment will be recovered and over which the unrealised loss on the debt instrument will reverse.
Entity A has historically had no taxable profits that tax law classifies as capital gains, nor does it expect any such taxable profits in the future.

Entity A assesses separately for each deductible temporary difference whether sufficient taxable profits will be available against which that deductible temporary difference can be utilised because tax law does not offset capital losses against ordinary gains, nor does it offset ordinary losses against capital gains.

Entity A recognises a deferred tax asset arising from the deductible temporary difference of 30 associated with the item of property, plant and equipment because it is probable that it will have sufficient taxable profits in periods in which the deductible temporary difference reverses.

Recognising a deferred tax asset arising from the deductible temporary difference associated with the debt instrument would require sufficient probable taxable profits of appropriate type (ie profits that applicable tax law classifies as capital gains).

Entity A does not have sufficient taxable temporary differences of the appropriate type (ie capital gains) reversing in the same periods as the reversal of the deductible temporary difference associated with the debt instrument (or in the periods into which a tax loss arising from that reversal could be carried back or forward). In addition, it is not probable that Entity A will have sufficient future taxable profits of appropriate type (ie capital gains) against which the deductible temporary difference associated with the debt instrument can be utilised.

Thus, Entity A does not recognise a deferred tax asset arising from the deductible temporary difference of 20 associated with the debt instrument unless a tax planning opportunity is available to create sufficient taxable capital gains in the future. Holding the debt instrument until it matures does not qualify as a tax planning opportunity because that action will not create taxable profits. Instead, it only prevents a capital loss from being realised.

Effective date

…

98C *Annual Improvements to IFRSs 2010–2012 Cycle* issued in [date] amended paragraphs 29 and 30, added paragraph 27A and 30A and added examples after paragraphs 29 and 30A. An entity shall apply that amendment for annual periods beginning on or after 1 January 2014. Earlier application is permitted. If an entity applies that amendment for an earlier period it shall disclose that fact.