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Project	**IAS 12 *Income Taxes*—Recognition of deferred tax assets for unrealised losses**
Paper topic	Analysis of different approaches

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Introduction

1. At its meeting in December 2012, the IASB tentatively decided to clarify the accounting for deferred tax assets for unrealised losses on debt instruments by a separate narrow-scope amendment to IAS 12 *Income Taxes*.

2. The IASB agreed with the IFRS Interpretations Committee ('the Interpretations Committee') that clarifying this issue requires addressing the question of whether:

   (a) an unrealised loss on debt instruments 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) an entity can assume that it will recover an asset for more than its carrying amount when estimating probable future taxable profits.

3. In addition, the IASB wants to discuss whether to amend IAS 12 to achieve an outcome for deferred tax accounting that would be consistent with the one that was recently discussed by the US-based Financial Accounting Standards Board (FASB) for the same type of debt instrument.

4. The IASB is asking the Interpretations Committee to discuss these three issues with the aim of presenting its recommendation on how to clarify the accounting for deferred tax assets for unrealised losses on debt instruments.

Objective of this paper

5. The objective of this paper is to:
   (a) provide an analysis of the three issues presented in paragraphs 2–3 of this staff paper; and
   (b) obtain a recommendation from the Interpretations Committee for the IASB on how to clarify the accounting for deferred tax assets for unrealised losses on debt instruments measured at fair value.

Structure of this paper

6. This agenda paper:
   (a) analyses whether there is 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) analyses 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;
   (c) explores the implications of applying the results from these analyses for the accounting for deferred tax assets for unrealised losses on debt instruments measured at fair value;
   (d) analyses whether IAS 12 should be amended to achieve an outcome for deferred tax accounting that was recently discussed by the FASB;
   (e) analyses further comments received on the Exposure Draft ('ED') *Annual Improvements to IFRSs 2010-2012 Cycle* published in May 2012;

(f) assesses the different options for clarifying the accounting for deferred tax assets for unrealised losses on debt instruments measured at fair value;

(g) makes a recommendation to the Interpretations Committee; and

(h) asks questions to the Interpretations Committee.

Illustrative Example

7. We want to illustrate our analysis by using the following example and modify it where necessary:

> **Fact pattern:**
>
> Entity A invests at the beginning of Year 1 CU1,000[1] in a 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 contractual interest rate of 2 per cent equals the market interest rate at the beginning and the end of Year 1. The market interest rate increases at the end of Year 2 to 5 per cent, 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.
>
> The debt instrument is held in a business model in which assets are managed both in order to collect contractual cash flows and for sale and is classified in the 'fair value through other comprehensive income' category ('FVOCI debt instrument')
>
> 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. The applicable enacted tax rate is 30 per cent.
>
> Entity A has no transactions in Years 1 to 5 other than the ones related to this debt instrument.

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

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

Period	Transaction	CU
Year 1	Investment in the 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

Is there 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?

Previous discussions

9. In Staff Paper 10E presented at the meeting of the Interpretations Committee in November 2012 and in Staff Paper 9 presented at the IASB meeting in December 2012 we supported the view that there is a deductible temporary difference from an unrealised loss on a debt instrument measured at fair value, even if the entity expects that the unrealised loss will reverse because the entity expects to collect all the contractual cash flows by holding the debt instrument to maturity ('the *view DTD also when holding*').

10. The difference between the carrying amount of the debt instrument (ie fair value) and its higher tax base gives rise to a deductible temporary difference, because the repayment of the principal is a taxable economic benefit and the tax base of the debt instrument can be offset against this taxable economic benefit.

11. Consequently, the temporary difference will result in an amount that is deductible against the receipt of the principal on the 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).

12. We supported this view because we thought that it better aligns with the concept of IAS 12 than the opposing view (ie that no deductible temporary arises if the entity expects to recover more than the carrying amount of the debt instrument by holding it to maturity and collecting all the contractual cash flows). In determining taxable profits (tax losses), the entity:

    (a) deducts the tax base of an asset

    (b) against any taxable economic benefit that flows to the entity

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

13. Proponents of the opposing view ('the *view DTD only on sale*') state that the repayment of the principal of the debt instrument measured at fair value in the example presented in paragraphs 7–8 of this Staff Paper does not reduce or increase tax payment. In other words, the reversal of the unrealised loss is a non-tax event. Consequently, they think that the difference between the carrying amount of the debt instrument measured at fair value and its higher tax base does not give rise to a deductible temporary difference if the entity expects to recover more than the carrying amount of the debt instrument by holding it to maturity and collecting all the contractual cash flows.

14. 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. The repayment of the principal of the debt instrument measured at fair value in the example above does not reduce or increase taxable profits (tax loss) because the tax base of the debt instrument 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.

Further analysis

15. The *view DTD also when holding* is also supported by paragraphs 20 and 26(d) of IAS 12:

    (a) Paragraph 26(d) of IAS 12 clarifies that a deductible temporary difference arises if the tax base of an asset exceeds its carrying amount of fair value.

    (b) Paragraph 20 of IAS 12, to which paragraph 26(d) of IAS 12 refers, lists IFRS 9 *Financial Instruments* as one of the Standards that permit or requires certain assets to be carried at fair value. It explains that the future recovery of the carrying amount of such an asset will result in a taxable flow of economic benefits to the entity and the amount of those benefits will differ from the amount that will be deductible for tax purposes.

16. Because of this explicit guidance in paragraph 20 and 26(d) of IAS 12 we think that is does not matter that:

    (a) the temporary difference resulting from the unrealised loss on the debt instrument measured at fair value reverses before the entity recovers the carrying amount of the asset; and

    (b) the future reversal of the temporary difference resulting from the unrealised loss on the debt instrument will not result in a deduction in determining taxable profits of future periods of all periods when the reversal occurs.

17. Paragraph 16 of IAS 12 instead reflects the assumption that a temporary difference reverses when the entity recovers the carrying amount of an asset and paragraph 27 of IAS 12 explains that the future reversal of deductible temporary differences will result in deductions in determining taxable profits of future periods when those reversals occur. Neither of these characteristics apply in the case of debt instruments measured at fair value if they are held until maturity. The deductible temporary difference reverses by maturity when the principal is repaid and the tax base of the debt instrument is deducted in determining taxable profits of future periods. At maturity however, the carrying amount of the debt

instrument equals its tax base, ie there is no longer a deductible temporary difference.

18. Finally, we think that the *view DTD also when holding* is also supported by the discussion of this issue under US GAAP by the FASB. The FASB assumed in this discussion that the unrealised loss on the debt instrument measured at fair value results in a deductible temporary difference. Paragraph 740-10-20 of Topic 740 *Income Taxes* in the *FASB Accounting Standards Codification®* defines deductible temporary differences similarly to paragraph 5 of IAS 12 as temporary differences that result in deductible amounts in future years when the related asset or liability is recovered or settled, respectively.

19. Consequently, we think that there is a deductible temporary difference even if the holder expects to recover the carrying amount of the asset by holding it to maturity and collecting all the contractual cash flows.

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?

Previous discussions

20. From the analysis of the comment letters on the IASB's ED we noted two different views that are applied in practice on whether an entity can assume that it will recover an asset for more than its carrying amount in estimating future taxable profits against which deductible temporary differences can be utilised (see paragraphs 88–93 of Staff Paper 10E presented at the November 2012 meeting of the Interpretations Committee):

    (a) ***View A*** *(temporary difference only)*: proponents of this view think that determining temporary differences and estimating probable future taxable profits are two separate issues and the inherent assumption of recovering an asset for its carrying amount in the Objective of IAS 12 and paragraphs 16 and 51 of IAS 12 only applies when determining temporary differences. For estimating future taxable profits against which deductible temporary differences can be utilised, it is instead the

probability criterion that drives the relevant assumptions. Consequently under this view, it may be possible to determine that the asset will be recovered for more than its carrying amount and thus a deferred tax asset may be recognised for up to the full amount of the deductible temporary difference.

(b) ***View B*** *(consistent assumptions)*: proponents of this view think instead that the assumption of recovering an asset for its carrying amount is relevant for both:

  (i) determining temporary differences; and

  (ii) estimating future taxable profits against which deductible temporary differences can be utilised.

  Under view B, accounting for deferred taxes must be based on consistent assumptions. Consequently, under this view the amount of the deferred tax asset recognised in respect of the deductible temporary difference will be limited, and potentially no deferred tax asset will be recognised if there are no other sources of taxable income against which to assess the utilisation of the deductible temporary difference.

21. In Staff Paper 10E presented at the meeting of the Interpretations Committee in November 2012 and in Staff Paper 9 presented at the IASB meeting in December 2012 we supported *View A (temporary difference only)*.

22. In our view, if it is probable that an entity will recover more than the carrying amount of an asset, the entity would include that excess recovery in its estimate of probable future taxable profits against which deductible temporary differences can be utilised.

23. In estimating these future taxable profits, the entity's estimates are not limited by the carrying amount of the assets in the statement of financial position.

24. Determining temporary differences and estimating probable future taxable profits are two separate issues. The inherent assumption of recovering an asset for its carrying amount in the Objective of IAS 12 and paragraphs 16 and 51 of IAS 12 applies when determining temporary differences. Instead, it is the probability criterion that drives the relevant assumptions when estimating future taxable profits against which deductible temporary differences can be utilised.

25. We supported this view for the following reasons:

Utilisation concept for deferred tax assets

26. We thought that *View A (temporary difference only)* aligns with the concept given in paragraph 24 of IAS 12, provided that such a gain is probable. Paragraph 24 of IAS 12 requires the assessment of the recognition of deferred tax assets on the basis of probable future taxable profits.

27. Estimating probable future taxable profits, however, implies considering events that take place after balance sheet date, including the realisation of profits from recovering the carrying amount of an asset.

28. We do not think that the balance sheet liability method, which focuses on temporary differences, requires an entity to assume that an asset is recovered only for its carrying amount in estimating probable future taxable profits.

29. The balance sheet method, which focuses on temporary differences, is the method required by IAS 12 (see paragraph IN2 of IAS 12) and the cause for the inherent assumption of recovering an asset for its carrying amount. This method focuses on the difference between the carrying amount of an asset or a liability in the statement of financial position and its tax base at balance sheet date. By doing so, it determines and limits the tax effects that an entity accounts for. It does not, however, indicate the conditions that will prevail when the temporary differences reverse and what tax consequences these reversals will have.

30. The conditions that will prevail when the temporary difference reverses, and the tax consequences this reversal will have are rather determined by the reporting entity's estimate of the future situation on the basis of tax law and other principles in IAS 12, such as the principle in paragraph 51 of IAS 12 that the measurement of deferred tax liabilities and deferred tax assets shall reflect the tax consequences that would follow from the manner in which the entity expects, at the end of the reporting period, to recover or settle the carrying amount of its assets and liabilities.

Appropriate results

31. In addition, we think that *View B (consistent assumptions)* leads to appropriate results in accounting for deferred tax assets in many cases.

32. This may be illustrated by the example of a profitable manufacturing entity that applies IAS 12 in accounting for its deferred tax assets and deferred tax liabilities.

33. A significant part of the assets of a manufacturing entity is usually property, plant and equipment and inventories and the assumption of recovering these assets for only their carrying amount conflicts with an expectation that the entity will generate future taxable profits.

34. This is because a significant part of their probable future taxable profits results from recovering existing (or indeed, future) assets for more than their carrying amount.

35. Only by assuming that a manufacturing entity will recover assets for more than their carrying amount, it is possible to assume that the manufacturing entity will generate future taxable profits, and thus be able to recognise deferred tax assets.

36. We think that this is an appropriate result and consistent with the broader principles in IAS12, because such profitable entities would be able to utilise the tax deductions resulting from the reversal of deductible temporary differences, ie the reversal of the deductible temporary difference will reduce their future tax payments.

37. The contrary view, *View B (consistent assumptions)* instead requires basing the entire accounting for deferred taxes on the assumption that all current (and perhaps future) assets are recovered only for their carrying amount. An entity that only recovers assets for their carrying amount would not record a profit.

38. For consistency, we think the assumption underlying *View B (consistent assumptions)* would have to apply not only to the asset that gave rise to the deductible temporary difference, but also to all the assets of the manufacturing entity.

39. However, this would mean that a profitable manufacturing entity would not:

(a) assume that it would achieve taxable profits by recovering property, plant and equipment and inventories, although this assumption would in many cases pass the probability criterion in paragraph 24 of IAS 12; and

(b) recognise the deferred tax assets that it expects will reduce future tax payments.

Further analysis

40. We still support *View A (temporary difference only)* after performing a further analysis on this issue.

41. Furthermore, we want to emphasise that the utilisation concept for deferred tax assets given in paragraph 24 of IAS 12 does not require *View B (consistent assumptions)*, ie to assume that an entity cannot recover an asset for more than its carrying amount.

42. We understand that the purpose of the utilisation concept is to ensure that deferred tax assets are only recognised, if it is probable that the tax deduction represented by the deductible temporary difference will result in a reduction of future tax payments. This is because only if the entity can offset tax deductions against probable future taxable profits and so reduce future tax payments, is an economic benefit embodied in the deferred tax asset and the recognition of a deferred tax asset, an asset, justified and required (see also paragraph 27 of IAS 12).

43. In order to ensure that an economic benefit is embodied in a deferred tax asset, it is relevant that sufficient future taxable profits are probable. It is not relevant whether this future taxable profits results from recovering an asset for its carrying amount at balance sheet date or for a higher amount.

44. Consequently, we think that the carrying amount of an asset does not restrict the estimate of future taxable profits against which deductible temporary differences can be utilised. In doing so, an entity may assume to recover an asset for more than its carrying amount, provided that recovery for more than the carrying amount is probable.

Illustration of the application of the results from the previous analyses for the accounting for deferred tax assets for unrealised losses on debt instruments measured at fair value

Basic scenario

45. Applying the results from the analysis (for ease of reference we are naming the approach following from the previous analysis 'the *IASB Staff approach*') to the illustrative example presented in paragraphs 7-8 of this Staff Paper, Entity A recognises the deferred tax asset of CU25 for the following reasons:

    (a) The unrealised loss on the debt instrument gives rise to a deductible temporary difference of CU82 because the tax base of the asset carried at fair value exceeds its carrying amount. This results from the fact that no adjustment is made for tax purposes for the change in the carrying amount.

    (b) Entity A assumes that it is probable that it will recover the debt instrument at CU1,020 at the end of Year 5, ie for more than its carrying amount at the end of Year 2 of CU918.

    (c) Assuming that Entity A recovers the debt instrument at CU1,020 at the end of Year 5, its *future taxable profit before deducting the amounts resulting from the reversal of deductible temporary differences* is CU102 (CU20 interest income for Year 5 plus CU82 tax deduction represented by the deductible temporary difference) for Year 5. '*Future taxable profit before deducting the amounts resulting from the reversal of deductible temporary differences*' is the taxable profit used to assess the utilisation of deductible temporary difference (for its determination please see paragraphs 32–56 of Staff Paper 9 presented at the December 2012 IASB meeting[2]). A future taxable profit before deducting amounts resulting from the reversal of deductible temporary differences of CU102 is sufficient to utilise the deductible temporary difference of CU82 and therefore to recognise the deferred tax asset of CU25.

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[2] http://www.ifrs.org/Meetings/MeetingDocs/IASB/2012/December/9-IAS12-1212.pdf

Modification (loss position)

46. The *IASB Staff approach* may be further illustrated by the following modification of the illustrated example presented in paragraphs 7-8 of the Staff Paper:

> The fact pattern is the same as in the basic scenario with the exception that Entity A has:
>
> - other transactions in Years 1 to 5 than the ones related to the debt instrument;
> - no deductible temporary differences other than the one related to the debt instrument;
> - no existing taxable temporary differences;
> - no taxable income in prior carryback year(s); and
> - no tax planning opportunities that it could implement.
>
> Entity A expects to file tax losses of CU1,000 each for the Years 1–5.

47. Applying the *IASB Staff approach* to the modified illustrative example presented the previous paragraph, Entity A does not recognise the deferred tax asset of CU25 for the following reasons:

    (a) The unrealised loss on the debt instrument gives rise to a deductible temporary difference of CU82 because the tax base of the asset carried at fair value exceeds its carrying amount. This results from the fact that no adjustment is made for tax purposes for the change in the carrying amount. This conclusion is unchanged compared with the analysis for the basic scenario (see paragraph 45(a) of this Staff Paper).

    (b) Entity A assumes that it is probable that it will recover the debt instrument at CU1,020 at the end of Year 5, ie for more than its carrying amount at the end of Year 2 of CU918. This conclusion is unchanged compared with the analysis for the basic scenario (see paragraph 45(b) of this Staff Paper).

    (c) Assuming that Entity A recovers the debt instrument at CU1,020 at the end of Year 5, its *future taxable profit before deducting the amounts resulting from the reversal of deductible temporary differences* for

Year 5 is CU-918 (CU1,000 tax loss expected to be filed for Year 5 plus CU82 tax deduction represented by the deductible temporary difference), ie still a tax loss. This tax loss of CU-918 is not sufficient to utilise the deductible temporary difference of CU82 and therefore to recognise the deferred tax asset of CU25. This conclusion differs from the conclusion for the basic scenario (see paragraph 45(c) of this Staff Paper).

48. For the ease of reference, we apply the term 'an entity in a *loss position*' in the following paragraphs to an entity that is in Entity A's tax position in the modified illustrative example. This tax position is that of an entity whose tax payments are not reduced by tax deductions resulting from the reversal of deductible temporary differences because it does not pay taxes anyway because of the amount of tax losses.

Should IAS 12 be amended to achieve an outcome for deferred tax accounting that would be consistent with the one recently discussed by the FASB?

49. Finally, the IASB asked the Interpretations Committee to analyse whether IAS 12 should be amended to achieve an outcome for deferred tax accounting that would be consistent with the one that was recently discussed by the FASB.

50. In the following paragraphs we therefore:

    (a) describe the issue under US GAAP;

    (b) summarise the history of the FASB's discussions;

    (c) analyse the revised FASB approach; and

    (d) compare it to IFRSs.

The issue under US GAAP

51. Topic 740, *Income Taxes*, in the *FASB Accounting Standards Codification®* ('Topic 740') requires an entity to follow specific guidelines to record a deferred tax asset and a deferred tax liability. These guidelines result in each entity

establishing temporary differences based on book versus tax differences at the balance sheet date. These differences are determined by amounts recorded in the balance sheet (ie a balance sheet approach).

52. According to paragraph 740-10-30-5 of Topic 740, deferred taxes should be determined separately for each tax-paying component (an individual entity or group of entities that is consolidated for tax purposes) in each tax jurisdiction. This determination includes the following procedures:

    (a) Identify the types and amounts of existing temporary differences and the nature and amount of each type of operating loss and tax credit carryforward and the remaining length of the carryforward period.

    (b) Measure the total deferred tax liability for taxable temporary differences using the applicable tax rate.

    (c) Measure the total deferred tax assets for deductible temporary differences and operating loss carryforward using the applicable tax rate.

    (d) Measure deferred tax assets for each type of tax credit carryforward.

    (e) Reduce deferred tax assets by a valuation allowance if, based on the weight of available evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realised. The valuation allowance should be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realised.

53. Topic 740 *Income Taxes* is however not explicit about whether the realisability of deferred tax assets is evaluated *individually* or *collectively* and this has resulted in two views being applied in practice when the need for a valuation allowance is assessed for a deferred tax asset relating to a change in the fair value recognised in other comprehensive income ('OCI') of debt instruments classified as available-for-sale:

    (a) **View 1:** the assessment of a valuation allowance for such a deferred tax asset should be done **discretely from** other deferred tax assets of an entity.

(b) **View 2:** the assessment of a valuation allowance for such a deferred tax should be done **in combination with** other deferred taxes of an entity.

History of FASB discussions

54. According to a request letter submitted to the FASB,[3] the SEC began discussing the issue '*Accounting for Deferred Tax Assets and Liabilities on Available-for-Sale Debt Securities That Are Expected to Be Held-to-Recovery and/or Held-to-Maturity*' ('the issue') in late 2008 following a request from some US GAAP preparers. According to the letter submitted to the FASB, the SEC staff concluded that they would not object to the application of either View 1 or View 2.

55. The issue arose when many entities had experienced significant operating losses and were not able to project future taxable income.

56. The request letter submitted to the FASB led to the issue being discussed by the EITF Agenda Committee at its meeting held on 15 January 2009,[4] before the FASB Chairman decided at the FASB Administrative meeting on 12 February 2009 to add this issue to the FASB agenda.[5]

57. At its meeting on 3 March 2010, the FASB continued the discussion of the issue within the context of the project on *Accounting for Financial Instruments*. Within this context, the FASB is discussing, and proposes to the change, the recognition and measurement of financial instruments. This is likely to include replacing Topic 320 *Investments—Debt and Equity Securities* and as part of this removing the available-for-sale category (see for example paragraph 27 of the 'Proposed

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[3] http://www.fasb.org/cs/BlobServer?blobkey=id&blobwhere=1175818463551&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs

[4] http://www.fasb.org/01-15-09_mtg_minutes.pdf

[5] http://www.fasb.org/0309REPORT.pdf

Amendments to the *FASB Accounting Standards Codification*®, published on 12 April 2013[6] ('the FASB's ED ASC amendments')).

58. Notwithstanding the proposed removal of the available-for-sale category, the deferred tax issue may not become obsolete, because the FASB is proposing to introduce the category 'financial instruments classified and measured at fair value through other comprehensive income' ('FVOCI financial instruments') for financial instruments. The 'Proposed Accounting Standards Update—*Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*' ('the FASB's ED 2013')[7] proposes this category in draft paragraphs 825-10-25-25(b) and 35-8(b) for financial assets:

    (a) whose contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding (the contractual cash flows characteristics criterion); and

    (b) that are managed along with other financial assets within a business model for which the objective is both to hold assets to collect contractual cash flows and to sell assets (the business model characteristics criterion).

59. At its meeting in question on 3 March 2010, the FASB tentatively decided to propose that deferred tax asset valuations on FVOCI debt instruments should be evaluated in combination with other deferred tax assets of an entity.[8]

60. On 26 May 2010, the FASB published the 'Proposed Accounting Standards Update—*Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities—Financial Instruments*

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6 http://www.fasb.org/cs/BlobServer?blobkey=id&blobwhere=1175826620388&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs

7 http://www.fasb.org/cs/BlobServer?blobkey=id&blobwhere=1175826620388&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs

8 http://www.fasb.org/jsp/FASB/Document_C/DocumentPage&cid=1176156725954

(Topic 825) and Derivatives and Hedging (Topic 815)' ('the FASB's ED 2010')[9] which included this proposal in paragraph 35.

61. In paragraph BC166 of its ED 2010 the FASB explained that it believed that:

    (a) deferred tax assets relating to the change in fair value of debt instruments measured at fair value with qualifying changes in fair value recognised in OCI should be accounted for consistently with other deferred tax assets and liabilities recognised for items recognised in OCI under Topic 740 on income taxes; and

    (b) this approach would be consistent with Topic 740's requirements that the ultimate income tax calculation should be based on the entity's entire tax position.

    The FASB believed that the tax calculation should not be segregated by the tax amounts on the entity's specific assets and liabilities.

62. At its meeting on 1 August 2012, the FASB discussed the feedback received on its ED 2010, regarding the evaluation of a valuation allowance on a deferred tax asset related to a debt instrument for which qualifying changes in fair value are recognised in OCI. The staff explained that stakeholders largely disagreed with the proposal in the FASB's ED 2010.[10] Generally, stakeholders noted that questions about the application of the guidance in Topic 740 should be considered in a comprehensive project on income taxes.

63. The FASB did not, however, take any decision on the issue at this meeting but directed the staff to perform additional analysis for discussion at a future meeting.[11]

64. This discussion took place at the FASB meeting on 3 October 2012[12] when the FASB tentatively decided that an entity should evaluate the need for a valuation

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[9] http://www.fasb.org/cs/BlobServer?blobkey=id&blobwhere=1175823559151&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs

[10] http://www.fasb.org/jsp/FASB/Document_C/DocumentPage&cid=1176160212322

[11] http://www.fasb.org/jsp/FASB/Document_C/DocumentPage&cid=1176160225848

[12] http://www.fasb.org/jsp/FASB/Document_C/DocumentPage&cid=1176160397639

allowance of deferred tax assets related to debt instruments classified and measured at fair value through other comprehensive income separately from its evaluation of other deferred tax assets[13] (‘the *revised proposal*’).

65. On 14 February 2013, the FASB published its ED 2013, which includes the *revised proposal* in draft paragraph 825-10-35-16.

66. The FASB explains in paragraph BC242 of its ED 2013 that the proposed approach might result in no valuation allowance and explains that it thinks that a valuation allowance may not be necessary, because a deferred tax asset related to such unrealised losses results from the interaction of Topic 740 and Topic 320 and is therefore unique. The proposed accounting acknowledges that this issue is a special case stemming from the interaction of accounting requirements and that the unrealised losses on debt instruments recognised in OCI are unrelated to other items that give rise to deferred tax assets. Consequently, the need for a valuation allowance should be evaluated separately.

67. Furthermore, paragraphs BC240–BC241 of FASB’s ED2013 summarise the feedback on the proposal in the FASB’s ED 2010:

    (a) The majority of respondents to the FASB’s ED2010 who commented on this issue focused on whether an entity has the intent and ability to hold an investment in a debt instrument until recovery of its amortised cost basis. If so, the recovery of the unrealised losses in OCI and the corresponding reversals of the deferred tax asset can be viewed as the realisation of its tax benefit.

    (b) Some respondents to the FASB’s ED 2010 also supported the proposed approach.

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

Analysis of the revised FASB approach

68. The analysis of 'the *revised FASB approach*' starts with analysing the arguments given by FASB in paragraph BC242 of its ED 2013 for proposing a revised approach:

    (a) the interaction of Topic 740 and Topic 320 makes a deferred tax asset related to unrealised losses on debt instruments recognised in OCI unique; and

    (b) the unrealised losses on debt instruments recognised in OCI are unrelated to other items that give rise to deferred tax assets.

69. Topic 320 *Investments—Debt and equity Securities* requires the following treatment for investments in debt securities that are classified as available-for-sale. An entity shall measure these investments subsequently at fair value in the statement of financial position (see paragraph 320-10-35-1(b) of Topic 320). Unrealised holding gains and losses for available-for-sale securities are excluded from earnings and reported in OCI until realised.

70. An interaction of Topic 740 *Income Taxes* and Topic 320 *Investments—Debt and Equity Securities* results from the fact that unrealised holding gains and losses for available-for-sale securities are excluded from earnings and reported in OCI until realised.

71. Topic 320 and Topic 740 reflect this particularity in paragraphs 740-20-45-11(b) and 320-10-45-3 and following (see also paragraph 740-20-60-1 of Topic 740). The accounting resulting from this interaction can be summarised as follows:

    (a) An entity recognises a deferred tax asset related to an unrealised holding loss on available-for-sale securities and credits the resulting deferred tax income directly to OCI (see paragraph 740-20-45-11(b) of Topic 740).

    (b) If the entity concludes at the day of the recognition of the deferred tax asset or later in the same fiscal period that a valuation allowance on the deferred tax asset is needed, the offsetting entry to the valuation

allowance (ie the resulting expense) is also recognised in OCI (see paragraph 320-10-45-3 of Topic 320).

(c) If the entity concludes in a subsequent fiscal year on the need for a valuation allowance, the entity no longer recognises the offsetting entry to the valuation allowance (ie the resulting expense) in OCI. Instead it recognises the offsetting entry to the valuation allowance (ie the expense) in income from continuing operations (see paragraph 320-10-45-4 of Topic 320).

(d) Reversals of the valuation allowance in subsequent fiscal years resulting from changes in the expectation about the realisation of the deferred tax asset in future years are recognised in income from continuing operations, even if the valuation allowance was recognised in OCI in a previous fiscal year (see paragraph 320-10-45-5).

72. The recognition of some of the above tax effects in OCI is an exception to the general rule that the income tax expense or benefit from the recognition of deferred tax assets and changes in the valuation allowance for the deferred tax assets are allocated to continuing operations (see paragraphs 740-20-45-1 to 45-9 of Topic 740).

73. For ease of reference we are naming the approach required by paragraphs 320-10-45-3 to 45-5 of Topic 320 the '*US GAAP approach for subsequent changes in the valuation allowance*'.

74. In its ED ASC amendments, the FASB proposes to combine the *US GAAP approach for subsequent changes in the valuation allowance* with the '*separate assessment approach*' for deferred tax assets related to unrealised losses on FVOCI financial instruments.

75. The combination of the *US GAAP approach for subsequent changes in the valuation allowance* and the *separate assessment approach* can be summarised as follows:

(a) An entity recognises a deferred tax asset related to an unrealised holding loss on FVOCI financial instruments and credits the resulting deferred tax income directly to OCI (see paragraph 740-20-45-11(b) of

the FASB's ED ASC amendments). This is unchanged compared with current US GAAP requirements.

(b) The entity assesses the need for a valuation allowance for deferred tax assets related to unrealised losses on these financial instruments separately from the entity's other deferred tax assets (see draft paragraph 825-10-35-16 of the FASB's ED ASC amendments). This is a change compared with current requirements.

(c) If the entity concludes at the day of the recognition of the deferred tax asset or later in the same fiscal period that a valuation allowance on this deferred tax asset is needed, the offsetting entry to the valuation allowance (ie the resulting expense) is also recognised in OCI (see draft paragraph 740-10-45-29 of the FASB's ED ASC amendments). This is unchanged to current requirements.

(d) If the entity concludes in a subsequent fiscal year on the need for a valuation allowance, the entity no longer recognises the offsetting entry to the valuation allowance (ie the resulting expense) in OCI. Instead it recognises the offsetting entry to the valuation allowance (ie the resulting expense) in income from continuing operations (see draft paragraph 740-10-45-30 of the FASB's ED ASC amendments). This is unchanged compared with current requirements.

(e) Reversals of the valuation allowance in subsequent fiscal year resulting from changes in the expectation about the realisation of the deferred tax asset in future years are recognised in income from continuing operations, even if the valuation allowance was recognised in OCI in a previous fiscal year (see draft paragraph 740-10-45-30 of the FASB's ED ASC amendments). This is unchanged compared with current requirements.

76. This separate assessment does not by itself conclude on whether a valuation allowance is recognised on the deferred tax assets related to unrealised losses on FVOCI financial instruments.

77. The FASB explains in paragraph BC242 of its ED 2013, however, that this proposal might result in providing no valuation allowance. We understand that no valuation allowance is provided if the view is applied that:

    (a) the recovery of the unrealised holding losses recognised in OCI; and

    (b) the corresponding reversal of the deferred tax asset resulting from the entity's intent and ability to hold an investment in a debt instrument until recovery of its amortised cost basis,

    is viewed as being the realisation of its tax benefit (see paragraph BC240 of the FASB's ED 2013).

78. Applying this view in combination with the *separate assessment approach* may result in not recognising a valuation allowance on such deferred tax assets, even though the entity will not pay any taxes in any case. This is because the effect of the reversal of the deferred tax asset might be only to avoid higher tax losses.

79. As explained above, the recovery of the unrealised loss recognised in OCI, and the corresponding reversal of the deferred tax asset, does not result from recovering more than the carrying amount of the asset but instead from the entity's intent and ability to hold the investment in the debt instrument until the unrealised loss is recovered. We understand that this is also the reason why the FASB considers the unrealised losses on debt instruments recognised in OCI as being unrelated to other items that give rise to deferred tax assets (see paragraph BC242 of the FASB's ED 2013).

80. This may be illustrated by the modified illustrative example in paragraph 46 of this Staff Paper.

81. Entity A will not pay any taxes within the foreseeable future, no matter what happens to the FVOCI debt instrument:

    (a) If it sells the asset while the market interest rate is higher than 2 per cent, it would realise the loss and so increase its tax loss that it expects to file in the year of the sale.

    (b) If it instead holds the debt instrument classified in the fair value through other comprehensive income category until maturity, interest income

will reduce the tax losses. Apart from this, the tax losses that it expects to file will not be affected by the debt instrument.

82. In summary, the recovery of the carrying amount of the FV OCI debt instrument will not change the fact that Entity A expects not to pay any taxes or to receive any repayments of taxes. This is because it expects only tax losses in the foreseeable future and it cannot carry these losses back and offset them with profits in the past. Entity A does not expect that realising the debt instrument will create taxable profits.

83. Although Entity A does not expect that the reversal of the deferred tax asset related to the unrealised holding loss might result in a reduction of its future tax payments, Entity A might not recognise a valuation allowance according to the *revised FASB approach*:

(a) First of all, Entity A recognises at the end of Year 2 a deferred tax asset of CU25 ((CU1,000 – CU918) × 30 per cent) by recognising the tax effect in OCI.

(b) Second, Entity A assesses the need for a valuation allowance of this deferred tax asset according to the *separate assessment approach* separately from other deferred tax assets at the end of Year 2.

(c) Third, Entity A considers:

(i) the recovery of the unrealised holding losses in OCI; and

(ii) the corresponding reversal of the deferred tax asset resulting from the entity's intent and ability to hold an investment in a debt instrument until recovery of its amortised cost basis,

as being the realisation of the tax benefit of the deferred tax asset.

(d) Consequently, no valuation allowance is recognised for the deferred tax asset related to the unrealised loss at the end of Year 2.

IFRS comparison

84. Both the current US GAAP accounting for deferred tax assets relating to unrealised holding losses on available-for-sale debt instruments and FASB's

proposed accounting for deferred tax assets relating to unrealised holding losses on FVOCI financial instruments differ from IAS 12 *Income Taxes:*

(a) First of all, the expectation that some part or all of the deferred tax assets will not be realised is reflected by a valuation allowance of the deferred tax assets under US GAAP. Under IFRS instead, paragraph 24 of IAS 12 requires that these parts of the deferred tax assets are not recognised (or no longer recognised) if sufficient future taxable profits are no longer probable. However, this different approach might not result in a different reflection of deferred tax assets in the statement of financial position or the statement of profit or loss and OCI.

(b) US GAAP limits backwards tracing because it does not allow the recognition of changes in the valuation allowance for deferred tax assets in subsequent annual periods in the same way as for the recognition of the deferred tax asset or the valuation allowance that has changed. Paragraphs 58 and following of IAS 12 require 'backwards tracing' instead. This means that deferred tax assets and changes to the deferred assets are recognised in OCI, if they are/were recognised, in the same or a different period, in OCI. It makes no difference whether the item to which the deferred tax relates was recognised in OCI in the same or a previous annual reporting period.

(c) Draft paragraph 825-10-35-16 of the FASB's ED ASC amendments requires an entity to assess the need for a valuation allowance on some deferred tax assets separate from other deferred tax assets, although tax law does not require such a separate assessment. Paragraphs 24 and 27 of IAS 12 instead require entities to assess the realisation/utilisation of deferred tax assets solely according to tax law. This means very often that for IFRS purposes an entity assesses the realisation/utilisation of a deferred tax asset in combination with its other deferred tax assets. If tax law restricts the utilisation of tax losses so that an entity can deduct the tax losses only 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. In other words, a separate assessment is only done if it is required by tax law not because of accounting requirements in IAS 12.

(d) We understand that many respondents to the FASB's ED 2010 hold the view that:

(i) the recovery of the unrealised holding losses in OCI; and

(ii) the corresponding reversal of the deferred tax asset resulting from the entity's intent and ability to hold an investment in a debt instrument until recovery of its amortised cost basis

is the realisation of its tax benefit. Paragraph 27 of IAS 12 instead explains that deferred tax assets are realised/utilised by offsetting the tax deductions represented by the deferred tax assets against future taxable profits. Consequently, the reversal of the deductible temporary difference resulting from holding the investment in a debt instrument until recovery of its amortised cost basis is not a tax benefit that allows the realisation/utilisation of the deferred tax asset. The tax benefit of the deferred tax assets in question is realised by deducting the entire tax base of the debt instrument against the taxable economic benefit from the repayment of the principal.

85. Applying IAS 12 to the modified illustrated example presented in paragraph 46 of this Staff Paper, it means that Entity A cannot recognised the deferred tax asset:

(a) At the end of Year 5, Entity A can offset the tax base of the debt instrument of CU1,000 against the taxable economic benefit of CU1,000 from the repayment of the principal.

(b) However, Entity A cannot recognise the deferred tax asset of CU25 because it does not have sufficient probable future taxable profits against which it could offset the tax deduction of CU1,000. Even if Entity A adds the taxable economic benefit of CU1,000 from the repayment of the principal to its expected tax loss of CU1,000 to assess the realisation/utilisation of the deductible temporary difference, it has a taxable profit/tax loss of nil. Offsetting a tax deduction of CU1,000 against a taxable profit/tax loss before tax deductions related to deferred

tax assets of CU nil results in a tax loss of CU1,000 and not in a reduction of future tax payments.

Analysing the relevance of the arguments of the FASB for IFRSs

86. The *separate assessment approach* that the FASB proposed in its ED 2013 is based on, and linked to, the introduction of the FVOCI financial instruments category.

87. The IASB is also proposing in its ED *Classification and Measurement: Limited Amendments to IFRS 9* (ED/2012/4) ('the IFRS 9 ED') to introduce such a category for financial assets.

88. Consequently, we discuss the arguments given by the FASB in its ED 2013 in order to see whether the *separate assessment approach* should also be introduced in IAS 12.

Interaction of Topic 740 and Topic 320

89. In paragraph BC242 of its ED 2013 the FASB explains that it thinks that a valuation allowance may not be necessary because a deferred tax asset related to unrealised losses on debt instruments recognised in OCI results from the interaction of Topic 740 and Topic 320 and is, therefore, unique.

90. As explained in paragraphs 69 and following of this Staff Paper, the interaction of Topic 740 and Topic 320 results from the fact that qualifying changes in the fair value of available-for-sale financial instruments are not recognised in income from continuing operations but in OCI. This raises the question or whether deferred tax assets, and deferred tax liabilities and changes in deferred tax assets and liabilities and changes in the valuation allowance on deferred tax assets, should also be recognised in OCI or in income from continuing operations instead.

91. The same issue arises for deferred tax assets and deferred tax liabilities related to available-for-sale financial instruments within the scope of IAS 39 and it would arise for FVOCI financial assets within the scope of a future IFRS 9 that had been amended following the IFRS 9 ED.

92. However, the 'interaction issue' only relates as far as IFRSs are concerned to where to present changes in deferred tax assets and deferred tax liabilities: in profit or loss or in OCI. It does not address the question of whether a deductible temporary difference can be utilised and therefore whether the related deferred tax asset can be recognised.

93. Utilising a deductible temporary difference requires sufficient future taxable profits against which the tax deduction resulting from the reversal of the deductible temporary difference can be utilised (see paragraphs 24 and 27 of IAS 12). This assessment has to be done by applying tax law and we think it is irrelevant for this assessment whether the tax effects represented by the deferred tax assets are recognised in profit or loss or in OCI in the IFRS financial statements.

94. Consequently, we do not think that the recognition of unrealised gains and losses on financial assets in OCI requires or justifies the separate assessment of the utilisation of deductible temporary differences related to unrealised losses on FVOCI debt instruments as far as IFRSs are concerned.

Unrelated to other items

95. In paragraph BC242 of its ED 2013, the FASB explains that it proposes the *separate assessment approach* because unrealised losses on debt instruments recognised in OCI are unrelated to other items that give rise to deferred tax assets.

96. As explained in paragraph 79 above, we understand that this is because the recovery of the unrealised loss results not from recovering the carrying amount of the debt instrument but instead from the entity's intention and ability to hold the investment in the debt instrument until recovery, which may be maturity.

97. While we agree with the reason for the recovery of the unrealised loss, we do not think that this fact requires or justifies the separate assessment of deferred tax assets related to such an unrealised loss as far as IFRSs are concerned.

98. Like all other deductible temporary differences, deductible temporary differences related to unrealised losses on FVOCI debt instruments represent tax deductions

beyond the carrying amount of an asset or a liability (see paragraphs 5 and 27 of IAS 12).

99. Like all other deferred tax assets, deferred tax assets related to unrealised losses on FVOCI debt instruments represent probable future reductions of tax payments (see paragraph 27 of IAS 12). Future tax deductions can only be achieved by offsetting the tax deductions resulting from recovering the carrying amount of an asset or settling a liability against probable future taxable profits.

100. Consequently, we do not think that the recognition of unrealised gains and losses on financial assets in OCI requires or justifies the separate assessment of the utilisation of deductible temporary differences related to unrealised losses on FVOCI debt instruments in applying IAS 12.

Realisation of the tax benefit

101. The FASB presented in paragraph BC240 of its ED 2013 the argument of many respondents to its ED 2010 that the recovery of the unrealised losses in OCI by holding an investment in a debt instrument until recovery of its amortised cost basis, and the corresponding reversals of the deferred tax asset, can be viewed as the realisation of its tax benefit.

102. We think that this view is inconsistent with the IFRS approach to deferred tax. This is because the tax benefit embodied in a deferred tax asset is the probable reduction of future tax payments through recovering the carrying amount of the underlying asset or settling the carrying amount of the underlying liability (see paragraph 27 of IAS 12).

103. The recovery of an unrealised loss in OCI and the corresponding reversal of the deferred tax asset by holding an investment in a debt instrument until recovery of its amortised cost basis does not represent an inflow of economic benefits. Instead, it simply reflects measurement adjustments for financial assets measured at fair value, for example resulting from the accretion of a discount in the fair value of the asset, that are recognised in the statement of financial position and in profit or loss and OCI.

104. We think this is not realising the tax benefit of a deferred tax asset by avoiding an outflow of economic benefits.

Analysing further comments on the ED **Annual Improvements to IFRSs 2010–2012 Cycle** *published in May 2012*

105. In the comment letter analysis presented at the Interpretations Committee meeting in November 2012, we did not further analyse comments that supported an approach to achieve an outcome for deferred tax accounting that would be consistent with the *revised FASB approach*. This is because such an approach is not in line with IAS 12 and would therefore be beyond the scope of the Annual Improvements project (see paragraph 60 of Staff Paper 10E presented at the November 2012 Interpretations Committee meeting[14]).

106. Now that we are analysing whether the accounting for deferred tax assets for unrealised losses on debt instruments measured at fair value should be clarified by a separate narrow-scope amendment to IAS 12, the limitations of the annual improvements project no longer apply and we think it is worthwhile to consider the comments supporting an amendment to IAS 12 that would achieve an outcome for deferred tax accounting that would be consistent with the revised FASB approach as well.

Inappropriate restriction on the recognition of deferred tax assets

107. The American Council of Life Insurers (ACLI) argued in their comment letter on the IASB's ED that it would be inappropriate to require future taxable profits for the recognition of a deferred tax assets related to unrealised losses on available-for-sale debt instrument in the circumstance in which the reversal of the deductible temporary difference for the unrealised loss on that debt instrument will not create a future tax deduction. This is because the carrying amount of the debt instrument will once again equal its tax base after recovery or on maturity.

108. We think this view is based on an inconsistency in their argument. If the difference between the carrying amount of an asset and its tax base will not result

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

in an amount that is deductible in determining taxable profit (tax loss) of future periods when the carrying amount of an asset or liability is recovered, the difference is not even a deductible temporary difference (see paragraph 5 of IAS 12) and a deferred tax asset cannot be recognised anyway.

Inaccurate view of an entity's financial position

109. ACLI further argues that currently there is only partial basic symmetry in accounting for unrealised gains and losses. While deferred tax liabilities are always recognised, deferred tax assets are only recognised if the tax deduction resulting from the reversal of the deductible temporary difference can be offset against probable future taxable profits.

110. ACLI thinks that the effect upon equity of this asymmetry is not the best reflection for the user of an entity's financial position. Both events, unrealised losses and unrealised gains, represent notional events for which there should be some basic symmetry. If an entity can support the assertion that it has the ability and intent to hold the available-for-sale debt instrument until recovery or maturity, this should be sufficient to recognise the deferred tax asset. It is inappropriate to require historical or projected income to offset a notional or hypothetical tax benefit.

111. We think that the asymmetry in accounting for deferred tax assets and deferred tax liabilities first of all reflects the way that the tax system works in most countries:

(a) If an entity makes a gain, tax law requires the entity in principle to give the government a share of this profit.

(b) If an entity makes a loss instead, tax law does not require the government to reimburse the entity for parts of its loss. Tax law may allow the entity only to offset that loss against gains.

112. Consequently, paragraph 24 of IAS 12 requires, for the recognition of deferred tax assets, that the utilisation of deductible temporary differences by offsetting them against future taxable profits is probable.

113. Considering the way that tax law works in most countries, it might however be argued that it not appropriate to recognise deferred tax liabilities for taxable

temporary differences, if the entity is in such a *loss position* that the reversal of the taxable temporary difference will only reduce the tax loss that the entity expects to file. It will not turn the expectation of the entity from filing a tax loss to filing a taxable profit and paying taxes.

114. Considering the way that tax law works in most countries, we think that addressing this issue could only result in amending the recognition requirements for deferred tax liabilities. It would not result in amending the recognition requirements for deferred tax assets.

115. For this reason, we think, however, that the issue is beyond the scope of this project, whose objective it is to clarify the accounting for certain deferred tax assets.

Non-economic equity volatility for life insurance companies

116. ACLI further argues that because of the size of life insurers' available-for-sale debt security portfolios, unrealised gains and losses can be extremely significant and cause unwarranted equity volatility.

117. Consider, for example, an available-for-sale debt instrument that decreases in value, but then recovers as the debt instrument matures. The volatility would not be smoothed by the recognition of a deferred tax asset. ACLI thinks that this is not a clear reflection of a life insurer's financial position when the entity has demonstrated its ability and intention to hold the available-for-sale debt instrument until recovery or maturity and can therefore avoid realising the loss.

118. To illustrate the increased equity volatility, ACLI submitted the example presented in Appendix A of this paper, which compares the equity effect for an entity that can recognise the deferred tax assets for unrealised losses on the debt instrument with an entity that cannot recognise such a deferred tax asset. This example is reproduced in Appendix A to this Staff Paper.

119. We agree with ACLI that not recognising the deferred tax assets related to unrealised losses on debt instruments measured at fair value increases the equity volatility.

120. We think this volatility might even be increased by fair value changes because of market volatility that turns an unrealised loss into an unrealised gain.

121. We also understand that this volatility might have regulatory implications for financial institutions.

122. However, we do not think that this justifies the recognition of a deferred tax if it would not embody an economic benefit. Equity volatility does not, in our view, imply an economic benefit of deferred tax assets.

123. Furthermore, we do not see what information the recognition of deferred tax assets for unrealised losses would give about Company's D resources and obligations in the example in Appendix A to this Staff Paper. Consider for example that the tax rate changes after the recognition of the deferred tax assets. The deferred tax assets would be adjusted to reflect the change in tax rate although the cash flows of Company D would not change. As an entity in a *loss position*, it will not pay taxes in any case.

Staff recommendation

124. After analysing the FASB's proposals and additional comments received on the ED *Annual Improvements to IFRSs* we recommend that:

    (a) the accounting for deferred tax assets for unrealised losses on debt instruments measured at fair value in accordance with IAS 12 should be clarified by applying the *IASB Staff approach*; and

    (b) the Interpretations Committee should ask the IASB for a tentative decision on the approach that is going to be the basis for the amendment before discussing further details and drafting the proposed amendment to IAS 12.

125. We do not think that IAS 12 should be amended to achieve an outcome for deferred tax accounting that would be consistent with the one proposed by the FASB for the same type of instruments (the *consistent outcome approach*) for the following reasons:

Deferral account

126. As long as the entity is not in a *loss position*, the *consistent outcome approach* results in the same presentation of deferred tax assets in the IFRS statement of financial position and the IFRS statement of profit or loss and other comprehensive income as the *IASB Staff approach*.

127. If the entity is, however, in a *loss position*, the *consistent outcome approach* would still result in recognising deferred tax assets related to unrealised losses recognised in OCI.

128. The *IASB Staff approach* would instead prohibit the recognition of these deferred tax assets, because it is not probable that future taxable profits will be available against which the deductible temporary differences can be utilised. Consequently, the deductible temporary differences will not result in reductions of future tax payments.

129. Consequently, we are not clear what the future economic benefit is that would justify recognising a deferred tax asset if the entity is in a *loss position*.

130. On the basis of this conclusion, we understand that the deferred tax assets for unrealised losses on debt instruments measured at fair value is, in the case of an entity in a *loss position*, not an 'asset' but a 'deferral account' as far as IFRSs are concerned.

131. We think IAS 12 should not be modified for recognising a deferral account, even if it would significantly smooth equity volatility.

Accounting mismatch

132. The conclusion for modifying IAS 12 to apply the *consistent outcome approach*, is not supported by the guidance in IFRSs to avoid accounting mismatch, if the modification would result in recognising a deferral account.

133. An alleged accounting mismatch from the partial basic asymmetry in accounting for deferred tax assets and deferred tax liabilities for unrealised losses (see paragraphs 109 and following of this Staff Paper) is different from examples given in the guidance on avoiding accounting mismatch in current IFRSs. This is

because recognising the deferred tax assets for unrealised losses on FVOCI debt instruments results in recognising deferred tax assets that we think do not embody an economic benefit.

134. The guidance on avoiding accounting mismatch in current IFRSs (see for example paragraph B4.1.29 of IFRS 9 *Financial Instruments*) may allow an entity to change:

(a) the measurement basis, eg fair value instead of amortised cost; or

(b) where those changes in fair value are recognised, eg recognising changes in fair value in OCI instead of profit or loss.

135. Such guidance does however not allow an entity to recognise items as assets that do not embody any economic benefit to avoid accounting mismatch and this is in our understanding the result from applying the *consistent outcome approach* to an entity is a *loss position*.

IASB Staff approach

136. On the basis of our analysis, we recommend the *IASB Staff approach*, because recognising deferred tax assets for unrealised losses on debt instruments subsequently measured at fair value, unless the holding entity is in a *loss position*, conforms to the basic mechanics of IAS 12 and is also appropriate in economic terms. An entity with such an unrealised loss is in a better tax position than an entity acquiring the debt instrument for its fair value at balance sheet date.

137. This may be illustrated by the example presented in paragraphs 7-8 of this Staff Paper:

(a) Entity A offsets a tax deduction of CU1,000 in Year 5 against its taxable economic benefits of CU1,020.

(b) Now suppose that another entity (Entity B) instead acquires the debt instrument measured at fair value at the end of Year 2 for its then carrying amount of CU918. Consequently, it can only deduct the tax base of CU918 against the economic benefits of CU1,020 in Year 5.

138. In other words, Entity A may, unlike Entity B, receive additional taxable economic benefits of CU82 without paying taxes. However, that ability to receive additional taxable economic benefits will be of no value to entity A if it would not otherwise have had to pay tax on those benefits.

139. Consequently, we think that the Interpretations Committee should recommend to the IASB that it should clarify the accounting for deferred tax assets for unrealised losses on debt instruments subsequently measured at fair value on the basis of the *IASB Staff approach*.

Next steps

140. We propose to clarify the accounting for deferred tax assets for unrealised losses on debt instruments measured at fair value by applying the *IASB Staff approach*.

141. We expect that clarifying the accounting for these deferred tax assets by applying the *consistent outcome approach* or the *IASB Staff approach* would result in significantly different amendments to IAS 12.

142. Consequently, we propose that the Interpretations Committee should ask the IASB for a tentative decision on the approach that is going to be the basis for the amendment before discussing further details and drafting a proposed amendment.

Questions to the IFRS Interpretations Committee

1. Do the Interpretations Committee members think that an economic benefit is embodied in a deferred tax asset for an unrealised loss on a debt instrument measured at fair value if the entity is in a *loss position*?
2. What comments do the Interpretations Committee members have on the staff analysis?
3. Does the Interpretations Committee agree with the staff recommendation?

Appendix A—ACLI example on equity volatility

dr/(cr) format

Example: Both entities (Entity C & Entity D) hold an available-for-sale debt security that decreased in value in Year 1, but then recovered as the security matured. Entity D could not recognise the deferred tax asset, while Entity C can.
Entity D has a more dramatic swing in equity because of the not recognising DTAs.

COMPANY C

	YEAR 1		YEAR 2		YEAR 3		YEAR 4		YEAR 5	
	BOY	EOY	BOY	EOY	BOY	EOY	BOY	EOY	BOY	EOY
Par, 5 Yr, 5%	200	200	200	200	200	200	200	200	200	200
FMV	200	150	200	163	200	175	200	188	200	200
Equity	200	174	174	189	189	203	203	218	218	233
Balance Sheet										
Cash		10	10	20	20	30	30	40	40	50
Bond	200	150	150	163	163	175	175	188	188	200
Current Tax (Pay) / Asset		(4)	(4)	(7)	(7)	(11)	(11)	(14)	(14)	(18)
Deferred Tax (Pay) / Asset		17	17	13	13	9	9	4	4	-
APIC	(200)	(200)	(200)	(200)	(200)	(200)	(200)	(200)	(200)	(200)
OCI		50	50	37	37	25	25	12	12	-
OCI - Dfrd Tax / (Bene)		(17)	(17)	(13)	(13)	(9)	(9)	(4)	(4)	-
Retained (Earnings)		(7)	(7)	(13)	(13)	(20)	(20)	(26)	(26)	(33)
Equity	(200)	(174)	(174)	(189)	(189)	(203)	(203)	(218)	(218)	(233)
check (s/b zero)	-	0	0	-	-	-	-	-	-	-
Change in Equity During Year		26		(14)		(15)		(15)		(14)

ACLI

dr/(cr) format

Example: Both entities (Entity C & Entity D) hold an available-for-sale debt security that decreased in value in Year 1, but then recovered as the security matured. Entity D could not recognise the deferred tax asset, while Entity C can.
Entity D has a more dramatic swing in equity because of the not recognising DTAs.

COMPANY D

	YEAR 1		YEAR 2		YEAR 3		YEAR 4		YEAR 5	
	BOY	EOY	BOY	EOY	BOY	EOY	BOY	EOY	BOY	EOY
Par, 5 Yr, 5%	200	200	200	200	200	200	200	200	200	200
FMV	200	150	200	163	200	175	200	188	200	200
Equity	200	157	157	176	176	195	195	214	214	233
Balance Sheet										
Cash		10	10	20	20	30	30	40	40	50
Bond	200	150	150	163	163	175	175	188	188	200
Current Tax (Pay) / Asset		(4)	(4)	(7)	(7)	(11)	(11)	(14)	(14)	(18)
Deferred Tax (Pay) / Asset		-	-	-	-	-	-	-	-	-
APIC	(200)	(200)	(200)	(200)	(200)	(200)	(200)	(200)	(200)	(200)
OCI		50	50	37	37	25	25	12	12	-
OCI - Dfrd Tax / (Bene)			-		-		-		-	-
Retained (Earnings)		(7)	(7)	(13)	(13)	(20)	(20)	(26)	(26)	(33)
Equity	(200)	(157)	(157)	(176)	(176)	(195)	(195)	(214)	(214)	(233)
check (s/b zero)	-	-	-	-	-	-	-	-		-
Change in Equity During Year		43		(19)		(19)		(19)		(19)

Abbreviations

BOY	=	Beginning-of-Year
EOY	=	End-of-Year
FMV	=	Fair Market Value
APIC	=	Additional Paid-In-Capital