IFRS

STAFF PAPER

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IFRS Interpretations Committee Meeting

IFRS IC meetings: May-Nov 2010, Nov 2012, May 2013
IASB meetings: Sep 2011, Dec 2012

Project	**IAS 12 *Income Taxes*—Recognition of deferred tax assets for unrealised losses**
Paper topic	Cover note—Project status and feedback from consultations with IASB members

CONTACT Thomas Harzheim tharzheim@ifrs.org +44 (0)20 7246 0552

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Introduction

1. At its meeting in May 2013, the IFRS Interpretations Committee (the 'Interpretations Committee') discussed three approaches that could be the basis for an amendment to IAS 12 *Income Taxes* to clarify the accounting for deferred tax assets (DTAs) for unrealised losses on debt instruments measured at fair value (FV).

2. The Interpretations Committee decided to recommend to the IASB one of these approaches as the basis for an amendment to IAS 12. This approach would result in the recognition of DTAs for unrealised losses on debt instruments measured at FV, unless recovering the debt instrument by holding it until an unrealised loss reverses does not reduce future tax payments and instead only avoids higher tax losses.

3. The Interpretations Committee noted that the different approaches would result in significantly different amendments to IAS 12. The Interpretations Committee therefore asked the staff to consult IASB members on possible approaches that could be the basis for an amendment to IAS 12.

4. Accordingly, the staff consulted IASB members at various meetings in October 2013 to obtain individual views from IASB members on possible approaches.

Objective of Staff Papers 2 and 2A

5. The purpose of Staff Papers 2 and 2A is to develop an approach on how to clarify the accounting for DTAs for unrealised losses on debt instruments measured at FV.

6. In this context, we have drawn on feedback from IASB members when developing our proposals to help us identify whether there are further issues, arguments or concerns that we think that the Interpretations Committee should consider before proposing a clarification to the IASB.

7. This Staff Paper does not include a draft amendment to IAS 12. We plan to present a draft amendment that considers the results from the discussions of the Interpretations Committee in January 2014 at a future meeting.

Structure of this Staff Paper

8. This cover note:

   (a) summarises the status of the project.

   (b) summarises the feedback from consultations with IASB members in October 2013.

   (c) asks a question to the Interpretations Committee.

9. The analysis of this issue is in Staff Paper 2A.

Project Status

Annual Improvements process

10. In March 2010, the Interpretations Committee received a request to clarify the accounting for DTAs when an entity:

   (a) has deductible temporary differences (DTDs) related to unrealised losses on debt instruments that are classified as available-for-sale financial assets ('AFS debt instruments') in accordance with IAS 39

Financial Instruments: Recognition and Measurement. AFS debt instruments are measured at FV and changes in their FV are recognised in Other Comprehensive Income (OCI);

(b) does not consider the AFS debt instruments to be impaired;

(c) has the ability and intention to hold the AFS debt instruments until the unrealised losses reverse (which may be at their maturity); and

(d) has insufficient taxable temporary differences (TTDs), and no other probable taxable profits, against which the entity can utilise those DTDs.

11. In response to the request received, the IASB proposed the following clarifications in the Exposure Draft *Annual Improvements to IFRSs 2010–2012 Cycle* (ED/2012/1), which was published in May 2012:

(a) an entity assesses whether to recognise the tax effect of a DTD as a DTA in combination with 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 (for example, if it can deduct capital losses only against capital gains), the entity must still assess a DTA in combination with other DTAs, but only with DTAs of the appropriate type.

(b) taxable profit against which an entity assesses a DTA for recognition is the amount before any reversal of DTDs.

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

12. In proposing these clarifications, the IASB followed a recommendation from the Interpretations Committee.

13. The Interpretations Committee discussed the comments received on the proposed amendment to IAS 12 in its meeting in November 2012 and identified a need for further discussion and analysis on two issues:

(a) whether an unrealised loss on a debt instrument measured at FV gives rise to a DTD if 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 DTDs can be utilised (see paragraph 24 of IAS 12).

14. The Interpretations Committee recommended that these two issues are resolved. 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 would need to be undertaken as a narrow-scope amendment to IAS 12. Consequently, the Interpretations Committee consulted the IASB on the most appropriate path forward.

15. At its meeting in December 2012, the IASB tentatively decided that the most appropriate path forward to clarify the accounting for DTAs for unrealised losses on debt instruments measured at FV 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 amount when estimating probable future taxable profits should be addressed in a narrow-scope project; and

(b) such a project, which goes beyond clarifications and corrections (ie a project with a broader scope than annual improvements), also allows for discussing whether to amend IAS 12 to achieve an outcome for deferred tax accounting that is consistent with the one that was recently discussed by the US-based Financial Accounting Standards Board (FASB), for debt instruments classified and measured at fair value through other comprehensive income ('FVOCI debt instruments').

16. Furthermore, the IASB noted that clarifying the issue requires addressing the question of whether an unrealised loss on a debt instrument measured at FV gives rise to a DTD, if the holder expects to recover the carrying amount of the asset by holding it to maturity and collecting all of the contractual cash flows.

Three approaches

17. At its meeting in May 2013, the Interpretations Committee discussed three approaches resulting from the issues raised by the IASB at its meeting in December 2012.

18. We want to illustrate the three approaches by using the following example:

Basic scenario—Only transactions related to FVOCI debt instruments

Fact pattern:

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

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 the 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').[2]

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 1–5 other than the ones related to this debt instrument. It therefore has no other sources of future taxable profits on which to justify the recognition of the deferred tax asset.

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

[2] This project does not analyse the accounting for DTAs for unrealised losses on debt instruments that are classified as available-for-sale financial assets. It analyses the accounting for debt instruments that are measured at fair value including debt instruments that are classified as financial assets measured at fair value through other comprehensive income. This is to reflect the changes from IFRS 9 *Financial Instruments* and the limited amendments that the IASB's project on classification and measurement of financial instruments proposes.

19. Entity A records the following inflows and outflows of economic benefits in Years 1–5:

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

Approach 1: No DTD if holding to maturity and collecting all the contractual cash flows

20. According to approach 1, no DTA is recognised if Entity A expects that it will hold the debt instrument to maturity and believes that it will collect all the contractual cash flows and thus recover the carrying amount of the debt instrument.

21. The difference of CU82 between the carrying amount of the debt instrument of CU918 in the statement of financial position (ie FV) and its tax base of CU1,000 at that date does not give rise to a DTD, according to approach 1. This is because this approach assumes that the unrealised loss will not result in an amount that is deductible in determining taxable profit (tax loss) of future periods (see definition of 'deductible temporary differences' in paragraph 5 of IAS 12).

22. In Year 5, the tax base of the debt instrument of CU1,000 equals the principal repaid of CU1,000. Consequently, the repayment of the principal of the debt instrument neither reduces nor increases taxable profit.

Approach 2: DTD irrespective of expected manner of recovery

23. On the basis of approach 2, Entity A would recognise a DTA of CU25 at the end of Year 2 for the difference of CU82 between the carrying amount of the debt instrument of CU918 in the statement of financial position (ie FV) and its tax base of CU1,000 at that date.

24. The difference between the carrying amount of the debt instrument and its higher tax base gives rise to a DTD even if Entity A expects to recover the carrying amount of the asset by holding it to maturity and collecting all the contractual cash flows.

25. This is because the repayment of the principal of CU1,000 at maturity is a taxable economic benefit and the entire tax base of the debt instrument of CU1,000 can be offset against this taxable economic benefit.

26. Consequently, the temporary difference of CU82 represents 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).

27. Entity A recognises the DTA of CU25. The deductible temporary difference of CU82 can be utilised because Entity A has no other transactions in Years 1–5 except for the transactions related to the debt instrument. For further details, reference is made to paragraph 45 of Staff Paper 12 presented at the May 2013 Interpretations Committee meeting.[3]

28. If Entity A believes that it is probable that it will receive the entire principal of CU1,000 and, therefore, recover the debt instrument for more than the carrying amount of CU918 it uses this assumption when estimating future taxable profits against which the DTD can be utilised.

29. In applying approach 2, unrealised losses on debt instruments measured at FV, DTAs are always recognised , unless recovering the debt instrument by holding it

[3] http://www.ifrs.org/Meetings/MeetingDocs/Interpretations%20Committee/2013/May/AP12-LSP-Recognition-deferred-tax-assets.pdf

until an unrealised loss reverses does not reduce future tax payments and instead only avoids higher tax losses (ie the entity is in a loss position). We want to illustrate the exception by using the following modification of the basic scenario:

Modification—Entity in a loss position

The fact pattern is the same as in the basic scenario with the exception that Entity A has:

- other transactions in Years 1–5;
- no DTDs 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. The tax losses do not result from the FVOCI debt instrument. Tax deductions related to the debt instrument are subordinated to all other tax deductions of Entity A according to tax law.

30. In applying the approach 2, Entity A does not recognise the DTA of CU25 related to the unrealised loss, because the utilisation of the DTD will not reduce future tax payments. Entity A will pay no tax (and recover no tax), and, because of the tax losses, the result would have been the same even if Entity A did not have the DTD. Thus, Entity A will derive no benefit from the DTD.

Approach 3: Consistent outcome approach

31. On the basis of an approach that results in an outcome that is consistent with the one that was recently proposed by the FASB, the ‘consistent outcome’ approach, Entity A would recognise a DTA of CU25 at the end of Year 2. In particular, Entity A would also recognise this DTA in the modification presented in paragraphs 29–30, ie when it is in a loss position.

32. This is because the approach recently proposed by the FASB is based on the assumption that:

(a) the difference of CU82 between the carrying amount of the debt instrument of CU918 in the statement of financial position (ie FV) and its tax base of CU1,000 at that date gives rise to a DTD;

(b) the utilisation of DTDs related to unrealised losses of FVOCI debt instruments is assessed separately from the utilisation of other DTDs; and

(c) the utilisation of these DTDs results from:

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

(ii) the corresponding reversals of the DTAs resulting from the entity's intent and ability to hold the investment in debt instruments until recovery of their amortised cost bases.

33. The FASB proposed this approach only for DTAs that are related to unrealised losses on financial instruments that are recognised in OCI. If gains and losses are recognised in profit or loss, the recognition and measurement of the related DTAs is assessed on the basis of the usual requirements.

Recommendation of the Interpretations Committee

34. At its meeting in May 2013, the Interpretations Committee decided to recommend to the IASB that the amendment to IAS 12 should be based on approach 2 'DTD irrespective of expected manner of recovery'.

35. The Interpretations Committee preferred this approach to approach 3 'consistent outcome approach' because:

(a) it is based on the existing utilisation assessment in paragraphs 24 and following of IAS 12; and

(b) it is not clear what economic benefit is embodied in a DTA, if recovering the debt instrument by holding it until an unrealised loss reverses does not reduce future tax payments and instead only avoids higher tax losses.

Feedback from consultations with IASB members

36. We consulted IASB members on the issue in various meetings in October 2013.

37. The feedback that we received from those consultations can be summarised as follows:

    (a) no IASB members expressed support for approach 1, the 'no DTD if holding to maturity and collecting all the contractual cash flows' approach.

    (b) most of the IASB members shared the Interpretations Committee's view that DTAs should not be recognised if recovering the debt instrument by holding it until an unrealised loss reverses does not reduce future tax payments and instead only avoids higher tax losses (ie if an entity is in a loss position).

    (c) however, several IASB members thought that it would be helpful to explain in what circumstances would recovering the debt instrument by holding it until an unrealised loss reverses not reduce future tax payments and instead only avoid higher tax losses (ie when DTAs for unrealised losses on debt instruments measured at FV are not recognised because the entity is in a loss position). We note that this is relevant because:

        (i) tax law usually determines taxable profit or tax loss on a combined basis and does not determine which tax deduction included in the net amount 'tax loss' reduces future tax payments and which of those tax deductions creates or increases tax losses, if any. Consider, for example, an entity that files a tax loss of CU300 that results from offsetting tax deductions of CU1,000 against taxable gains of CU700. Tax deductions of CU700 reduce the tax payments to nil whereas tax deductions of CU300 only create or increase the tax loss. Tax law does not usually specify which tax deductions included in the CU1,000 are offset against the taxable gains of CU700 and which tax deductions only create or increase the tax loss of CU300.

Consequently, if future tax deductions of CU1,000 include an unrealised loss on a debt instrument, the question arises whether the related DTD reduces future tax payments or only creates or increases tax losses.

(ii) in practice, banks and insurers usually hold debt instruments measured at fair value in portfolios, including unrealised losses on some assets and unrealised gains on other assets. Accordingly, DTDs arise from some of these assets while TTDs arise from others. Consequently, the question arises: when is an entity that holds such a portfolio in a loss position?

(d) one IASB member also suggested that it would helpful if any amendment to IAS 12 would explain, how to determine which part of the deferred tax expense is recognised in OCI and which part is recognised in profit or loss in the scenario in which not all of the DTDs are recoverable (see paragraph 37(c)(i)).

(e) only a minority of IASB members were not concerned about recognising DTAs if recovering the debt instrument by holding it until an unrealised loss reverses does not reduce future tax payments and instead only avoids higher tax losses. However, those IASB members asked the Interpretations Committee to consider the effect on the equity of banks and insurers if entities in such a loss position cannot recognise DTAs for unrealised losses on FVOCI debt instruments. They asked the Interpretations Committee to think about the volatility in equity and the additional pressure on banks and insurers resulting from the approach recommended by the Interpretations Committee and in combination with regulatory minimum capital requirements. Furthermore, they expressed concerns about the creation of a difference compared with US GAAP for these types of DTAs, in particular a GAAP difference that would put preparers of IFRS financial statements in a less advantageous position than preparers of US GAAP financial statements. We note that the 'consistent outcome approach' would help address the points raised by those IASB members.

Question for the Interpretations Committee

Question for the Interpretations Committee
1. Do the Interpretations Committee members have any questions or comments on the status of the project or the feedback from our consultations with IASB members?