IFRS

STAFF PAPER

January 2014

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	Appendix A—Approach for clarification and staff recommendation

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Objective of this Staff Paper

1. The purpose of this Staff Paper is to develop an approach on how to clarify the accounting for deferred tax assets (DTAs) for unrealised losses on debt instruments measured at fair value (FV).

2. In this context, we have also drawn on feedback from our consultation with 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 that will be discussed in a public IASB meeting. For the summary of the feedback from the small-group meetings in October 2013, see paragraphs 36–37 of Staff Paper 2.

Structure of the Staff Paper

3. The Staff Paper therefore:

   (a) develops a general approach for the clarification.

   (b) analyses what aspects of the issue should be addressed by the clarification.

   (c) makes a staff recommendation.

(d) asks a question to the Interpretations Committee.

General approach for clarification

4. We think that the main focus of the amendment should be to illustrate how the existing principles in IAS 12 have to be applied in accounting for DTAs for unrealised losses on debt instruments measured at FV. We reach this conclusion for the following reasons:

   (a) we understand from the discussions of the Interpretations Committee on the issue that the existing principles in IAS 12 result in an appropriate reflection of DTAs for unrealised losses on debt instruments measured at FV in the financial statements. In particular, the approach that the Interpretations Committee preferred at its meeting in May 2013 is based on the existing principles of IAS 12. Consequently, the purpose of the amendment to IAS 12 would not be to introduce new or amended principles into IAS 12, but instead to explain the application of the existing principles.

   (b) we do not think that the Interpretations Committee should change its recommendation because of the concerns that some IASB members raised (see paragraph 37(e) of Staff Paper 2). The Interpretations Committee developed its recommendation considering these concerns. In other words, the concerns are not new to the Interpretations Committee. The effect on the equity of banks and insurers that some IASB members are concerned about has already been discussed by the Interpretations Committee at its meeting in May 2013 (see paragraphs 109–135 of Staff Paper 12 presented at the May 2013 Interpretations Committee meeting).[1] Furthermore, this Staff Paper outlined the difference the recommended approach compared with US GAAP as

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

proposed by the FASB and the Interpretations Committee noted this differences in the May 2013 IFRIC Update.[2]

(c) we understand from the analysis of the comment letters on the Exposure Draft *Annual Improvements to IFRSs 2010–2012 Cycle* (the 'ED') and from discussions with commentators and other interested parties that there is, above all, uncertainty about the application of some of the principles in IAS 12. Most of them agreed with the general clarifications in the ED (see paragraph 11 of Staff Paper 2) that:

(i) an entity assesses whether to recognise the tax effect of a deductible temporary difference (DTD) as a DTA in combination with other DTAs. If tax law restricts the utilisation of tax losses so that an entity can only deduct the tax losses 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.

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

(iii) 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.

However, on the basis of these clarifications and the (other) principles in IAS 12, the commentators and the interested parties reached divergent conclusions for the fact pattern discussed in the second example that was included in the proposed amendment (see the example after draft paragraph 30A of IAS 12 in the ED). They reached divergent conclusions on whether the DTA related to the debt instrument measured at FV is recognised although they applied the same proposed clarifications and principles.

[2] http://media.ifrs.org/2013/IFRIC/May/IFRICUpdateMay2013.pdf

(d) furthermore, several commentators criticised that the ED proposed three general clarifications (see (b)) to specify the accounting in the very specific fact pattern raised with the Interpretations Committee (for the fact pattern see paragraph 10 of Staff Paper 2). Even commentators on the ED who agreed with the three proposed clarifications were concerned about unintended consequences.

5. Considering these arguments, we think that the clarification of the accounting for DTAs for unrealised losses on debt instruments measured at FV should first of all consist of an illustrative example. Such an illustrative example would address the issue raised with the Interpretations Committee by illustrating the application of IAS 12 on the basis of a scenario in which this issue is relevant in practice. The illustrative example would explain what aspects of IAS 12 are being applied and why.

6. Other amendments to IAS 12 should be made only if the clarification through an illustrative example is insufficient.

7. We understand that such an illustrative example should be drafted considering the following assumptions:

(a) the issue raised with the Interpretations Committee is relevant in particular for banks and insurers.

(b) banks and insurers hold portfolios of debt instruments measured at FV.

(c) a large part of the unrealised gains and losses on these debt instruments and the related deferred taxes are recognised in other comprehensive income (OCI).

(d) the tax base of these debt instruments is usually some sort of cost basis.

(e) unrealised gains and losses on these debt instruments that are neither taxable nor tax deductible until realised.

(f) holding portfolios of debt instruments measured at FV usually implies that both taxable temporary differences (TTDs) and DTDs arise within a portfolio at the same time (on different debt instruments).

(g) tax law sometimes distinguishes between capital gains and losses and ordinary income and losses. While capital losses can only be offset against capital gains, ordinary losses can in some jurisdictions be offset against both, capital gains and ordinary income.

(h) it is not probable that the bank or insurers can utilise all the DTDs, because all three sources of taxable profits together are insufficient for the recognition of all DTAs.

(i) in the case that taxable profits are insufficient for the recognition of all DTAs, it is not clear which ones are recognised. This is important because some of them are recognised in profit or loss whereas others are recognised in OCI.

Aspects that need to be addressed by the illustrative example

8. On the basis of the previous discussions of the Interpretations Committee and the IASB on the accounting for DTAs for unrealised losses on debt instruments measured at FV, we think that the illustrative example would need to explain the following aspects in the application of the principles of IAS 12.

9. With the exception of the last two aspects, this Staff Paper merely reports the results from previous discussions of the Interpretations Committee. We do not re-discuss the other aspects and the conclusions reached on them. For the technical analysis of these issues we make reference to:

   (a) Staff Paper 12 presented at the May 2013 Interpretations Committee meeting; [3]

   (b) Staff Paper 9 presented at the December 2012 IASB meeting; [4] and

   (c) Staff Paper 10E presented at the November 2012 Interpretations Committee meeting. [5]

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

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

Existence of a DTD

10. An unrealised loss on a debt instrument measured at FV always gives rise to a DTD. Such an unrealised loss gives rise to a DTD even if the holder of the debt instrument expects to recover the carrying amount of the debt instrument by holding it to maturity and collecting all of the contractual cash flows.

11. The cash inflow at maturity of the debt instrument is a taxable economic benefit that flows to the entity in future periods, and the tax base of the debt instrument is a tax deduction.

12. Consequently, a tax base of a debt instrument that is higher than its carrying amount because of an unrealised loss gives rise to a DTD.

13. For further details, see paragraphs 9–19 of Staff Paper 12 presented at the May 2013 Interpretations Committee meeting.

14. We think that paragraphs 7, 16, 20 and 26(c) of IAS 12 combined with an illustrative example would clarify this.

15. However, a DTD resulting from an unrealised on a debt instrument measured at FV will reverse before the debt instrument is recovered on maturity, if the unrealised loss is due solely to a market interest rate that is higher than the nominal interest rate on the debt instrument.

16. This may be illustrated by the example in paragraph 18 of Staff Paper 2. The unrealised loss of CU82 at the end of Year 2 results from the difference between the market interest rate of 5 per cent and the nominal interest rate of the debt instrument of 2 per cent. Consequently, the unrealised loss of CU 82 at the end of Year 2 that gives rise to the DTD will reverse until maturity of the debt instrument at the end of Year 5 either because of a change in the market interest rate or simply because of the passage of time.

17. Paragraphs 16 and 27 of IAS 12, however, reflect the assumption that a temporary difference related to an asset reverses when the carrying amount of the asset is recovered.

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

18. Consequently, we think that paragraph 20 of IAS 12 should be amended to clarify that a temporary difference related to assets measured at FV might reverse before the carrying amount of an asset is recovered. Such a clarification would help to avoid confusion. We think that paragraph 20 of IAS 12 should be amended because the issue is relevant for assets and liabilities measured at FV.

Combined assessment

19. An entity assesses the utilisation of a DTD in combination with other DTDs. If tax law, however, restricts the utilisation of DTDs so that an entity can only utilise certain tax deductions against taxable profits of a specific type (for example, if it can deduct capital losses only against capital gains), the entity must still assess a DTD in combination with other DTDs, but only with DTDs of the appropriate type.

20. For further details, see paragraphs 66–74 of Staff Paper 9 presented at the December 2012 IASB meeting and paragraphs 21–63 of Staff Paper 10E presented at the November 2012 Interpretations Committee meeting.

21. We think that paragraph 27 of IAS 12 in combination with an illustrative example which addresses this issue would be sufficient to clarify this aspect.

22. Consequently, a further amendment to IAS 12 to clarify this would not be needed.

Probable future taxable profit before deducting amounts resulting from the reversal of DTDs

23. The recognition of DTAs requires that sufficient taxable profits will be available against which the DTDs can be utilised (see paragraph 24 of IAS 12).

24. Paragraphs 28 and 29 of IAS 12 identify three sources of taxable profits against which an entity can utilise DTDs. They are:

    (a) future reversal of existing TTDs;

    (b) future taxable profits; and

    (c) tax planning opportunities.

25. When there are insufficient TTDs relating to the same taxation authority and the same taxable entity, DTAs are recognised to the extent that probable future taxable profits or tax planning opportunities are available (see paragraph 29 of IAS 12).

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

27. It is a net amount that results from offsetting tax deductions against taxable profits. In other words, it is the net of amounts (for example, gains, inflows of taxable economic benefits, etc.) that are taxable in a specific period and amounts (for example, losses, amortisations, etc.) that are tax deductible in a specific period. All these amounts are determined by tax law.

28. Amounts that are tax deductible in a future period give rise to DTDs, if they relate to a temporary difference in the current period (see the definition of 'deductible temporary differences' in paragraph 5 of IAS 12 and paragraph 27 of IAS 12).

29. Consequently, the probable future taxable profit against which DTDs are assessed for utilisation (see paragraph 29(a) of IAS 12) differs from the taxable profit upon which income taxes are payable. Taxable profit upon which income taxes will be payable in future periods is after deducting amounts for which DTDs exist in the current period. Consequently, these tax deductions have to be excluded from the net amount to determine the probable future taxable profit against which DTDs are assessed for utilisation. Otherwise, an entity would consider tax deductions twice and, accordingly, need, for example, taxable amounts of CU200 to utilise a DTD of CU100.

30. In order to assess the utilisation of DTDs, amounts for which DTDs exist in the current period are also excluded from the net amount if it is probable that the net amount that will be filed is a tax loss upon which income taxes are recoverable (see paragraph 5 of IAS 12). Excluding tax deductions might turn a tax loss into a taxable profit that would allow to utilise parts of the DTDs existing in the current period.

31. For further details, see paragraphs 32–56 of Staff Paper 9 presented at the December 2012 IASB meeting and paragraphs 21–63 of Staff Paper 10E presented at the November 2012 Interpretations Committee meeting.

32. The difference between the taxable profit that is defined in paragraph 5 of IAS 12 and the taxable profit that used to assess the utilisation of DTDs is not reflected in the guidance in paragraphs 24 and following of IAS 12, although it is relevant for the assessment of all DTDs, not only DTDs related to unrealised losses on debt instruments measured at FV.

33. Consequently, we recommend a clarification in paragraphs 24 and following of IAS 12 on this issue next to the explanations in the illustrative example.

Recovering an asset for more than its carrying amount

34. If it is probable that an entity will recover an asset for more than its carrying amount, the entity will include the probable recovery when estimating future taxable profits against which DTDs can be utilised.

35. 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. Determining temporary differences and estimating future taxable profits against which DTDs are assessed for utilisation are two separate issues and the carrying amount is only relevant for the former issue.

36. Consequently, in estimating future taxable profits, an entity considers all the contractual cash flows that it is probable the entity will receive from a debt instrument rather than only the cash flows that equal the lower carrying amount of the debt instrument.

37. For further details, see paragraphs 20–39 of Staff Paper 12 presented at the May 2013 Interpretations Committee meeting.

38. We think that a clarification to paragraph 24 and following of IAS 12 would be needed because IAS 12 does not explain that the carrying amount of an asset is

only relevant for determining temporary differences and the objective of IAS 12 and paragraphs 16 and 51 of IAS 12 might be understood as indicating otherwise.

39. Furthermore, this issue was one of the issues that caused the IASB to clarify the accounting for DTAs for unrealised losses on debt instruments measured at FV in a limited-scope project, ie a project with a broader scope than the Annual Improvements process.

Entity in a loss position

40. Several IASB members suggested that it would be helpful to explain when DTAs for unrealised losses on debt instruments measured at FV are not recognised, because 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. In other words, they thought it could be helpful if the amendment would explain when an entity is in a loss position.

41. An entity is in a loss position if it cannot utilise all the DTDs. Consequently, it does not recognise DTDs to the extent in which their utilisation is not probable (see paragraph 24 of IAS 12).

42. We think that this should be illustrated by the example that we propose to add to IAS 12 for an entity that expects not to utilise all its DTDs.

43. In addition, paragraphs 28 and 29 of IAS 12 identify three sources of taxable profits against which an entity can utilise DTDs. They are:

    (a) future reversal of existing TTDs;

    (b) future taxable profits; and

    (c) tax planning opportunities.

44. Consequently, we think that the recognition of DTAs related to unrealised losses on debt instruments measured at FV should be illustrated by a scenario in which it is probable that the entity will utilise only part of its DTDs, because all three sources of taxable profits are available but together insufficient for the recognition of all DTAs.

45. We think that paragraphs 24 and following of IAS 12 together with an illustrative example addressing this issue are sufficient for a clarification. Another clarification in IAS 12 is not needed.

Split between profit or loss, OCI and other items

46. DTAs for unrealised losses on debt instruments measured at FV are recognised in OCI, if the unrealised loss is recognised in OCI (see paragraph 61A(a) of IAS 12).

47. DTAs related to other items instead might be recognised in profit or loss, as part of goodwill recognised in a business combination or directly in equity (see paragraphs 58 and 61A(b) of IAS 12).

48. Consequently, the question arises what amount of deferred tax is recognised in OCI for DTAs for unrealised losses on debt instruments measured at FV if not all DTAs can be recognised?

49. One IASB member considered it could helpful to clarify this in the amendment to IAS 12.

50. We think that paragraph 63 of IAS 12 requires a reasonable pro rata allocation if tax law does not require a different allocation.

51. We think that paragraph 63 of IAS 12 is sufficient for a clarification if it is combined with an illustrative example addressing this issue. Another clarification in IAS 12 is not needed.

Staff recommendation

52. We recommend that the clarification of the recognition of DTAs for unrealised losses on debt instruments measured at FV consists of an illustrative example and a few other clarifications to IAS 12 as outlined in the previous paragraphs.

53. If the Interpretations Committee agrees with the staff recommendation, we would draft an amendment to IAS 12 that would address the points raised in the staff analysis. As a first step, we would circulate this draft outside an Interpretations Committee meeting. As a second step, we would present in a future meeting a

draft that considers the comments from Interpretations Committee members with the aim of finalising the recommendation of the Interpretations Committee to the IASB.

Question for the Interpretations Committee

Question for the Interpretations Committee
2. Does the Interpretations Committee agree with the staff recommendation? If not, what alternative do you recommend?