STAFF PAPER

June 2014

IASB Meeting

IFRS IC meetings: May–Nov 2010,
Nov 2012, May 2013, Jan and Mar 2014
IASB meetings: Sep 2011, Dec 2012
and May 2014

Project	**Recognition of Deferred Tax Assets for Unrealised Losses (Proposed amendments to IAS 12)**
Paper topic	Amending mandatory guidance, transition and other drafting issues

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

This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

Introduction

1. At its meeting in May 2014, the IASB asked the staff to analyse how the mandatory guidance in IAS 12 *Income Taxes* could be amended to clarify that:[1]

   (a) an unrealised loss on a debt instrument measured at fair value gives rise to a deductible temporary difference even if:

      (i) the debt instrument holder expects to recover the carrying amount of the debt instrument by holding it to maturity and collecting all of the contractual cash flows; and

      (ii) the loss is not tax-deductible until realised (**existence of a deductible temporary difference**).

   (b) an entity assesses the utilisation of deductible temporary differences related to unrealised losses on debt instruments measured at fair value in combination with other deductible temporary differences. If tax law, however, restricts the utilisation of deductible temporary differences so that they are deductible only against the taxable profits of a specific type, the

[1] http://media.ifrs.org/2014/IASB/May/IASB-Update-May-2014.pdf

entity still assesses utilisation of such deductible temporary differences in combination with other deductible temporary differences, but only of the appropriate type. An example of such a restriction could be, for example, that capital losses are deductible only against capital gains (**combined assessment of utilisation**).

(c) an entity's estimate of future taxable profit, made for the purposes of recognising deferred tax assets, assumes that it will recover an asset for more than its carrying amount, if the recovery of an asset for more than its carrying amount is probable (**recovering an asset for more than its carrying amount**).

Purpose and structure of this Staff Paper

2. In order to meet the IASB's request, this Staff Paper analyses how the mandatory guidance of IAS 12 can be amended to clarify issues (a)–(c) in paragraph 1 of this paper (see paragraphs 4–27).

3. Furthermore, this Staff Paper also analyses the need for specific transition requirements (see paragraphs 28–40) and other drafting issues (see paragraphs 41–50).

Amending mandatory guidance of IAS 12

4. In the following paragraphs, we analyse for the issues that the IASB wants to clarify in the mandatory guidance of IAS 12:

   (a) what mandatory guidance IAS 12 already gives on these issues and why the existing guidance does not result in a consistent application (*reason why clarification is needed*); and

   (b) what type of additional guidance could be added to the mandatory parts of IAS 12 to clarify the requirements (*staff proposal for clarification*).

Existence of a deductible temporary difference

5. At its meeting in May 2014, the IASB tentatively decided to clarify in the mandatory guidance of IAS 12:

   An unrealised loss on a debt instrument measured at fair value gives rise to a deductible temporary difference even if (i) the debt instrument holder expects to recover the carrying amount of the debt instrument by holding it to maturity and collecting all of the contractual cash flows, and (ii) the loss is not tax deductible until realised.

   Reason why clarification is needed

6. We think the conclusion in paragraph 5 of this paper results from an exact application of paragraphs 20 and 26(d) of IAS 12. This is because the cash inflow at maturity of the debt instrument is a taxable economic benefit to the entity in future periods, and the tax base of the debt instrument is a tax deduction.

7. However, the IFRS Interpretations Committee (the 'Interpretations Committee') observed that this conclusion is not self-evident for a fixed-rate debt instrument measured at fair value that pays interest at the end of each year and the principal is repaid on maturity when the holder also deducts the tax base of the asset. This is because on maturity the tax deduction from deducting the tax base will be counterbalanced by the cash inflow of the same amount from the repayment of the principal of the debt instrument and will therefore appear not to reduce the taxable profit upon which income taxes are paid (see paragraph 5 of IAS 12).

   Staff proposal for clarification

8. Consequently, we think that the best way to clarify the application of the guidance in paragraphs 20 and 26(d) of IAS 12 to a fixed-rate debt instrument is to add an example after paragraph 26(d) of IAS 12. This example should explain the identification of a deductible temporary difference in the case of an unrealised loss on a fixed-rate debt instrument measured at fair value that pays interest at the end of each year and the principal is repaid on maturity when the holder also deducts the tax base of the asset. Such an example would be part of the mandatory guidance of IAS 12.

Combined assessment of utilisation

9. At its meeting in May 2014, the IASB tentatively decided to clarify in the mandatory guidance of IAS 12:

   An entity assesses the utilisation of deductible temporary differences related to unrealised losses on debt instruments measured at fair value in combination with other deductible temporary differences. If tax law, however, restricts the utilisation of deductible temporary differences so that they are deductible only against the taxable profits of a specific type, the entity still assesses utilisation of such deductible temporary differences in combination with other deductible temporary differences, but only of the appropriate type. An example of such a restriction could be, for example, that capital losses are deductible only against capital gains.

   Reason why clarification is needed

10. The conclusion in paragraph 9 of this paper results from paragraphs 5, 24 and 27 of IAS 12.

11. Paragraph 24 of IAS 12 requires that deferred tax assets are recognised to the extent that the probable future taxable profits will available against which the deductible temporary differences can be utilised. It is not a recognition choice.

12. Paragraph 27 of IAS 12 explains that deductible temporary differences are utilised when the tax deductions resulting from their reversal are offset against taxable profits of future periods and so reduce future tax payments.

13. In addition, it is tax law that determines the taxable profits against which specific tax deductions are offset. This is because taxable profit is defined in paragraph 5 of IAS 12 as the profit of a period that is determined in accordance with the rules established by the taxation authorities and upon which income taxes are payable.

14. Consequently, all deductible temporary differences, for which tax law offsets the tax deductions resulting from their reversal against the same taxable profit, have to be assessed for utilisation in combination with each other. Only such a combined

assessment can determine whether taxable profits are sufficient to utilise deductible temporary differences.

15. However, the fact that the conclusions in paragraph 9 are not explicitly given in IAS 12 but result from a combined analysis of three paragraphs has resulted in diversity in practice on how to group deductible temporary differences when assessing their utilisation.

Staff proposal for clarification

16. Consequently, we think that the conclusions in paragraph 9 could be made explicit in the mandatory part of IAS 12.

17. Considering that tax law determines the grouping of deductible temporary differences for the assessment of their utilisation, we think that corresponding guidance could be included in a paragraph following paragraph 27 of IAS 12, for example, like draft paragraph 27A that was included in the Exposure Draft *Annual Improvements to IFRSs 2010–2012 Cycle*[2] (the Annual Improvements ED). The Annual Improvements ED included the following draft paragraph 27A:

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

18. We noted general support for this clarification from the comment letter analysis on the Annual Improvements ED.

---

[2] http://www.ifrs.org/Current-Projects/IASB-Projects/Annual-Improvements/ED-May-2012/Documents/EDAnnualImprovementstoIFRSs20102012_WEBSITE.pdf

Recovering an asset for more than its carrying amount

19. At its meeting in May 2014, the IASB tentatively decided to clarify in the mandatory guidance of IAS 12:

    An entity's estimate of future taxable profit, made for the purposes of recognising deferred tax assets, assumes that it will recover an asset for more than its carrying amount, if the recovery of an asset for more than its carrying amount is probable.

    Reason why clarification is needed

20. IAS 12 does not explicitly address whether an entity's estimate of probable future taxable profit (see paragraph 29 of IAS 12) against which deductible temporary differences are assessed for utilisation is limited by the carrying amounts of the assets in the statement of financial position, even if a recovery of the assets for more than their carrying amounts is probable.

21. Paragraph 29(a) of IAS 12 only requires that future taxable profits are probable and available for the utilisation of the respective deductible temporary differences.

22. The Interpretations Committee noted that this lack of explicit and specific guidance has resulted in diversity in practice.

    Staff proposal for clarification

23. We think that a clarification could be added to paragraph 29 of IAS 12, to explain that an entity assumes that it will recover an asset for more than its carrying amount when such a recovery for more than the carrying amount is probable.

24. When we originally proposed such an amendment to paragraph 29 of IAS 12 to the Interpretations Committee, it disagreed with our proposal. The Interpretations Committee was concerned that this clarification in the mandatory part of IAS 12 might lead entities to assume that they would recover assets for more than their carrying amounts when this assumption would be inappropriate; for example, in many cases when non-financial assets such as investment properties assets are measured at fair value. Accordingly, the Interpretations Committee thought that this self-evident

conclusion should only be included in the Basis for Conclusions of IAS 12 and the non-mandatory illustrative example that should be added to IAS 12.

25. While we agree with the Interpretations Committee that it is not always appropriate to assume that an entity will recover an asset for more than its carrying amount, we are not convinced that this fact gives an argument against adding the clarification to paragraph 29 of IAS 12. This is because in cases in which it is not appropriate to assume that an entity will recover an asset for more than its carrying amount, such a recovery is not probable. In other words, the clarification to paragraph 29 of IAS 12 reflects the fact that it is not always appropriate to assume that an entity will recover an asset for more than its carrying amount.

26. Considering the concern of the Interpretations Committee, however, we recommend to clarify the issue by a combination of both:

    (a) a clarification should be added to paragraph 29 of IAS 12, to explain that an entity assumes that it will recover an asset for more than its carrying amount when such a recovery for more than the carrying amount is probable; and

    (b) the Basis for Conclusions on IAS 12 should further explain that it is not always probable that an asset will be recovered for more than its carrying amount and list some facts and circumstances that could influence the assumption.

27. In addition, the issue would be addressed in the non-mandatory illustrative example.

Transition

28. We analyse the need for specific transition requirements separately for entities already applying IFRS and entities adopting IFRS for the first time.

Entities already applying IFRS

29. If a Standard does not include specific transitional arrangements, paragraphs 19 and 23 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*

require changes in accounting policy to be applied retrospectively unless it is impracticable to do so. In determining whether the proposed amendments should also propose specific transitional arrangements, we analyse what information would be required for retrospective application and whether retrospective application would require the use of judgements that could be affected by hindsight.

30. Retrospective application of the proposals in general requires information at the date of the opening statement of financial position of the earliest period presented and subsequently. For the most part, no information is required for earlier dates, because the deferred tax assets and liabilities depend solely on the carrying amount and tax base of asset and liabilities at the end of the reporting period, assessments of the rates at that date and assessments of recoverability at that date.

31. However, information is required for earlier dates in relation to the changes in the allocation of tax between profit or loss, other comprehensive income and equity resulting from a retrospective application of the proposals. Retrospective application of those amendments would require information from earlier dates in order to determine the amount of tax that would have been recognised in other comprehensive income or equity. This amount needs to be known for disclosure and subsequent recognition in profit or loss of amounts previously recognised in other comprehensive income.

32. We did not identify any proposed changes that could require judgements that could be affected by hindsight if the date of the opening statement of financial position for the earliest period presented is before the final amendments to IAS 12 are issued. The carrying amounts (fair value) of debt instruments, their tax bases (cost), the estimate of probable future taxable profit and the basis for allocating (changes in) deferred tax between profit or loss, other comprehensive income and equity are known. The adjustments resulting from the proposed amendments to IAS 12 to the deferred tax accounting are mechanical in nature.

33. However, a re-analysis of the cumulative amounts that are recognised other comprehensive income and equity in the opening statements of financial position should not be required, because it could involve a substantial re-analysis of amounts going back many years and could be costly.

34. We think the cost of this full retrospective application outweigh its benefits.

35. Consequently, we recommend proposing, for entities already applying IFRS, a mandatory limited retrospective application of the proposed amendments in the opening statement of financial position for the first annual period starting on or after the effective date of the proposed amendments. Accordingly, transfer between retained earnings and other components of equity in the opening statement of financial position to restate cumulative amounts previously recognised in profit or loss, other comprehensive income or directly in equity should not be required. Full retrospective application should be permitted.

First-time adopters of IFRS

36. There are no special transitional arrangements for IAS 12 in IFRS 1 *First-time Adoption of International Financial Reporting Standards*. Retrospective application is required.

37. Consequently, a first-time adopter of IFRS would face a similar situation as an entity that already applies IFRS. In order to apply the proposed amendments to IAS 12, first-time adopters would not need to collect information from before the date of the opening statement of financial position of the first period presented (ie the date of transition to IFRS) with one exception: they would need to collect information on the cumulative amount of tax that would have been recognised in other comprehensive income.

38. However, this is a requirement that many first-time adopters of IFRS have to meet and notwithstanding IFRS 1 does not include an exception to, or exemption from, the retrospective application of this requirement.

39. In other words, IFRS 1 considers the cost and effort of first-time adopters of IFRS for determining the cumulative amounts that are recognised in other comprehensive income and directly in equity in the opening statement of financial position to be appropriate.

40. Consequently, we think that the proposed amendments to IAS 12 should not propose a consequential amendment to IFRS 1.

Other drafting issues

41. With drafting the amendments to IAS 12 in mind, we also want to raise the following issues with the IASB:

Probable future taxable profits

42. At its meeting in May 2014, the IASB also tentatively agreed with the recommendation of the Interpretations Committee that paragraphs 24–31 of IAS 12 should be amended. They should be amended to clarify that an entity's estimate of probable future taxable profits against which existing deductible temporary differences are assessed for utilisation excludes tax deductions represented by those deductible temporary differences.

43. Considering that the amendment clarifies the taxable profit that is used to assess the utilisation of deductible temporary differences we think the clarification should be included in paragraph 29 of IAS 12, for example, like the draft paragraph 29(a) that was included in the Exposure Draft *Annual Improvements to IFRSs 2010–2012 Cycle*[3] (the Annual Improvements ED). The Annual Improvements ED included the following draft paragraph 29(a) (new text is underlined):

> When there are insufficient taxable temporary differences relating to the same taxation authority and the same taxable entity, the deferred tax asset is recognised to the extent that:
>
> (a) it is probable that the entity will have sufficient taxable profit relating to the same taxation authority and the same taxable entity in the same period as the reversal of the deductible temporary difference (or in the periods into which a tax loss arising from the deferred tax asset can be carried back or forward). In evaluating whether it will have sufficient taxable profit in future periods, an entity:

[3] http://www.ifrs.org/Current-Projects/IASB-Projects/Annual-Improvements/ED-May-2012/Documents/EDAnnualImprovementstoIFRSs20102012_WEBSITE.pdf

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

(ii) ignores taxable amounts arising from deductible temporary differences that are expected to originate in future periods, because the deferred tax asset arising from these deductible temporary differences will itself require future taxable profit in order to be utilised; or

(b) tax planning opportunities are available to the entity that will create taxable profit in appropriate periods.

44. We noted general support for this clarification from the comment letter analysis on the Annual Improvements ED.

Illustration in the context of IFRS 9 Financial Instruments

45. At its meeting in May 2014, the IASB also tentatively agreed with the recommendation of the Interpretations Committee that the illustrative example should explain the application of IAS 12 to debt instruments measured at fair value in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* as well as those measured at fair value in accordance with IFRS 9 *Financial Instruments*.

46. Changes in the fair value of such debt instruments and a related deferred tax (see paragraphs 58 and 61A of IAS 12) are either recognised in profit or loss or other comprehensive income.

47. Consequently, the application of IAS 12 could be explained for unrealised losses on debt instruments measured at fair value that are recognised in profit or loss and/or other comprehensive income.

48. Considering that the issue of these amendments to IAS 12 arose within the context of unrealised losses that are recognised in other comprehensive income, we recommend that the illustrative example should explain the application of IAS 12 to debt instruments that are:

    (a) classified as available-for-sale financial assets (IAS 39); and

    (b) categorised as financial assets that are measured at fair value through other comprehensive income (IFRS 9).

49. At its meeting in November 2013, the IASB tentatively decided to amend the classification and measurement requirements for financial assets in IFRS 9 to introduce a third measurement category, 'fair value through other comprehensive income'.[4] Specifically, a financial asset is measured at fair value through other comprehensive income if both of the following conditions are met:

    (a) The financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets.

    (b) The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

50. The current IFRS 9, in contrast, does not allow the holder of a debt instrument that is measured at fair value to recognise an unrealised loss on the debt instrument in other comprehensive income.

Summary of recommendations

51. Summarising the analysis, we recommend that the proposed amendments to IAS 12 should:

    (a) clarify in an example (application guidance) following paragraph 26(a) of IAS 12 the application of the guidance in paragraphs 20 and 26(d) of

[4] http://media.ifrs.org/2013/IASB/November/IASB-Update-November-2013.pdf

IAS 12 in the case of an unrealised loss on a fixed-rate debt instrument measured at fair value that pays interest at the end of each year and the principal is repaid on maturity when the holder also deducts the tax base of the asset.

(b) add a paragraph after paragraph 27 of IAS 12 that clarifies that an entity assesses the utilisation of deductible temporary differences related to unrealised losses on debt instruments measured at fair value in combination with other deductible temporary differences. If tax law, however, restricts the utilisation of deductible temporary differences so that they are deductible only against the taxable profits of a specific type, the entity still assesses utilisation of such deductible temporary differences in combination with other deductible temporary differences, but only of the appropriate type.

(c) add a sentence to paragraph 29 of IAS 12 that explains that an entity assumes to recover an asset for more than its carrying amount when such a recovery for more than the carrying amount is probable. In addition, the Basis for Conclusions should further explain that it is not always probable that an entity will recover an asset for more than its carrying amount.

(d) propose for entities already applying IFRS a mandatory limited retrospective application of the proposed amendments in the opening statement of position for the first annual period starting on or after the effective date of the proposed amendments. Accordingly, transfer between retained earnings and other components of equity in the opening statement of financial position to restate cumulative amounts previously recognised in profit or loss, other comprehensive income or directly in equity should not be required. Full retrospective application should be permitted.

(e) not propose an exception to, or exemption from, the retrospective application of IFRS for the proposed amendments to IAS 12 for first-time adopters of IFRS.

(f) amend paragraph 29 of IAS 12 to clarify that an entity's estimate of probable future taxable profit against which deductible temporary

differences are assessed for utilisation excludes tax deductions represented by those deductible temporary differences.

(g) illustrate the application of IAS 12 to debt instruments that are:

(i) classified as available-for-sale financial assets (IAS 39); and

(ii) categorised as financial assets that are measured at fair value through other comprehensive income (IFRS 9 as it is to be amended by the limited amendments to the requirements in IFRS 9 for the classification and measurement of financial assets).

Questions for the IASB

Questions for the IASB
1. Do the IASB members have any questions on the staff analysis and the staff recommendations? 2. Does the IASB agree with the staff recommendations?