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Project	**IAS 12 *Income Taxes*—Recognition of deferred tax assets for unrealised losses**
Paper topic	Cover note—Proposed wording for the draft amendments to IAS 12

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

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Introduction

1. This paper sets out the proposed wording for the draft amendments to IAS 12 *Income Taxes.*

Amendments to IAS 12 *Income Taxes*

Paragraph 29 is amended and paragraph 98E is added. New text is underlined. Paragraphs 24 and 28 have not been amended but are included for ease of reference.

Deductible temporary differences

24 **A deferred tax asset shall be recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised, unless the deferred tax asset arises from the initial recognition of an asset or liability in a transaction that:**

(a) is not a business combination; and

(b) at the time of the transaction, affect neither accounting profit nor taxable profit (tax loss).

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

…

28 It is probable that taxable profit will be available against which a deductible temporary difference can be utilised when there are sufficient taxable temporary differences relating to the same taxation authority and the same taxable entity which are expected to reverse:

(a) in the same period as the expected reversal of the deductible temporary difference; or

(b) in periods into which a tax loss arising from the deferred tax asset can be carried back or forward.

29 When there are insufficient taxable temporary differences relating to the same taxation authority and the same taxable entity, the deferred tax is recognised to the extent that:

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

(i) compares the deductible temporary differences with those future taxable profits that exclude tax deductions resulting from the reversal of those deductible temporary differences. This comparison shows the extent to which the future taxable profit is 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.

In estimating future taxable profit, an entity assumes to recover an asset, including an asset to which a deductible temporary difference is related, for more than its carrying amount in the statement of financial position, if such a recovery is probable.

…

Effective date

…

98E *Recognition of Deferred Tax Assets for unrealised losses* (Amendments to IAS 12), issued in [date], amended paragraph 29. An entity shall apply that amendment for annual periods beginning on or after [date]. Earlier application is permitted. If an entity applies that amendment for an earlier period it shall disclose that fact.

Basis for Conclusions on the amendments to IAS 12 *Income Taxes*

This Basis for Conclusions accompanies, but is not part of, the proposed amendment.

Recognition of deferred tax assets for unrealised losses

BC1 The IFRS Interpretations Committee (the 'Interpretations Committee') was asked to provide guidance on how an entity determines, in accordance with IAS 12 *Income Taxes*, whether to recognise a deferred tax asset when:

(a) the entity has unrealised losses on debt instruments that are classified as available-for-sale financial assets in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* ('AFS debt instruments'). AFS debt instruments are measured at fair value after recognition with gains and losses recognised in other comprehensive income (OCI), except for impairment losses and foreign exchange gains and losses, until the debt instruments are derecognised.

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

(c) the tax base of the AFS debt instruments is some sort of cost basis.

(d) tax law does not allow losses to be deducted on debt instruments until they are realised.

(e) the entity has the ability and intention to hold the available-for-sale debt instruments until the unrealised losses reverse (which may be at their maturity).

(f) tax law distinguishes between capital gains and losses and ordinary income and losses. While capital losses can only be offset against capital gains, ordinary losses can be offset against both, capital gains and ordinary income.

(g) the entity has insufficient taxable temporary differences and no other probable taxable profits against the entity that can utilise those losses.

BC2 The Interpretations Committee reported to the Board that practice differed because of divergent views on the following questions:

(a) Does an unrealised loss on a debt instrument measured at fair value give rise to a deductible temporary difference if the holder does not expect that the unrealised loss will reduce taxable profit (tax loss) that will be filed for tax purposes? This is because the entity expects to hold the debt instrument until maturity and to collect all the contractual cash flows, ie the tax loss will reverse before maturity (see paragraphs BC3–BC7).

(b) Does an entity assume to recover an asset for more than its carrying amount in the statements of financial position when estimating probable future taxable profit against which deductible temporary differences are assessed for utilisation? This question is particularly relevant when taxable profit from other sources is insufficient for the utilisation of the deductible temporary differences resulting from the unrealised losses. In this case, an entity might only be able to recognise the related deferred tax assets, if it can assume to collect the entire cash flows from the debt instrument and therefore to recover it for more than its carrying amount (see paragraphs BC8–BC13).

(c) When an entity assesses whether it can utilise a deductible temporary difference against probable future taxable profit, does that probable future taxable profit include the effects of reversing deductible temporary differences (see paragraphs BC14–BC15)?

(d) Does an entity assess whether a deferred tax asset is recognised for each deductible temporary difference separately, or in combination with other deductible temporary differences? This question is particularly relevant when tax law distinguishes capital gains and losses from other taxable gains and losses and capital losses can only be offset against capital gains (see paragraphs BC16–BC18).

Existence of a deductible temporary difference

BC3 In the case of many debt instruments, the repayment of the principal on maturity does not increase or decrease taxable profit that is filed for tax purposes. This is the case, for example, if an entity invests CU1,000 in a debt instrument with a maturity of 5 years.[1] Interest is paid at the contractual rate each year, and on maturity of the debt instruments the issuer repays the principal of CU1,000. In this example, the investor only pays taxes on the interest income if it holds the debt instrument until maturity.

BC4 The Interpretations Committee observed that the fact that the repayment of the principal does not have any effect on the taxable profit that is filed for tax purposes leads many to the conclusion that the repayment of the principal is a non-tax event. Consequently, they think that a difference between the carrying amount of the debt instrument in the statement of financial position and its tax base does not give rise to a deductible temporary difference, if this difference results from a loss that they expect will not be realised.

BC5 They think that the loss will not be realised if they have the ability and intention to hold the debt instrument until the unrealised loss reverses (which might be until maturity) and if they do not consider the debt instrument to be impaired. In other words, they expect to receive all the contractual cash flows or equal cash flows from third parties. Such differences between the carrying amount of the debt instrument in the statement of financial position reverse over the period to maturity just by holding it. They arise, for example, if the market interest rate that is reflected in the fair value of the debt instrument is higher than the contractual interest rate.

BC6 The Board considered the guidance in IAS 12 on the identification of temporary differences. Paragraphs 20 and 26(d) of IAS 12 specify that a difference between the carrying amount of an asset measured at fair value and its higher tax base gives rise to a deductible temporary difference. The tax base of the debt instrument is deducted against the inflow of taxable economic benefits resulting from the repayment of the principal. The fact that the repayment of the principal does not affect taxable profit that is filed for tax purposes results from the fact that the tax base equals the inflow of taxable economic benefits.

BC7 The economic benefit embodied in the related deferred tax asset results from the fact that the holder of the debt instrument can achieve taxable gains in the amount of the deductible temporary difference without paying taxes on it. In contrast, an entity that acquires the debt instrument described in paragraph BC3 for its lower fair value (for example, CU870) and holds it to maturity has to pay taxes on a gain of CU130 whereas the entity in the example in paragraph BC3 will not pay any taxes because of the repayment of the principal.

Recovering an asset for more than its carrying amount

BC8 The Board noted that paragraph 29 of IAS 12 identifies future taxable profit as one source of taxable profits against which an entity can utilise deductible temporary differences. Future taxable profit has to be probable to justify the recognition of deferred tax assets. Consequently, only the conditions that will probably prevail when the deductible temporary differences are utilised determine future taxable profit.

BC9 Although this guidance does not make reference to the carrying amount of assets in the context of estimating probable future taxable profit, some think that the carrying amount of an asset to which a temporary difference is related limits the estimate of future taxable profit. They argue that accounting for deferred taxes has to be based on consistent assumptions, which implies that an entity cannot assume for one and the same asset:

(a) to recover it for its carrying amount when determining deductible temporary differences and taxable temporary differences; as well as

(b) to recover it for more than its carrying amount when estimating probable future taxable profit against which deductible temporary differences are assessed for utilisation.

[1] Monetary items in this Agenda Paper are denominated in 'currency units' (CU).

BC10 Consequently, proponents of this view think that an entity cannot assume to collect the entire principal of CU1,000 in the example in paragraph BC3. Instead they think it must assume to collect only the part of the principal that equals the carrying amount of the asset, ie fair value.

BC11 The Board noted however that determining temporary differences and estimating probable future taxable profit against which deductible temporary differences are assessed for utilisation are two separate steps and the carrying amount is only relevant for the former one.

BC12 Moreover, limiting the estimate of probable future taxable profits against which deductible temporary differences are assessed for utilisation to the carrying amount of assets would lead to inappropriate results. For consistency purposes, this limitation should not only apply to assets to which temporary differences are related. It should rather apply to all assets of the entity and may therefore conflict with the assumption that an entity is profitable, even if profitability is probable. 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. 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. 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. 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.

BC13 The Board proposes to amendment paragraph 29(a) of IAS 12 to clarify the requirements for estimating future taxable profits.

Probable future taxable profit against which deductible temporary differences are assessed for utilisation

BC14 During its work on the issue, the Interpretations Committee observed uncertainty about how to define probable future taxable profits against which deductible temporary differences are assessed for utilisation when they seem to be insufficient for the recognition of all deferred tax assets. The uncertainty related to whether deductible temporary differences should be compared with probable future taxable profit, excluding tax deductions that are represented by those deductible temporary differences, or including them.

BC15 The Board noted that deductible temporary differences are utilised by deduction against the amount of taxable profit excluding tax deductions that are represented by those deductible temporary differences. If not, the deduction would be counted twice. The Board proposes to amend paragraph 29(a) of IAS 12 to clarify this.

Combined versus separate assessment

BC16 The Board considered the guidance in IAS 12 on the recognition of deferred tax assets. Paragraph 24 of IAS 12 requires that deferred tax assets are recognised only to the extent of probable future taxable profit against which the deductible temporary differences can be utilised. Paragraph 27 of IAS 12 elaborates on these requirements and explains that:

(a) the deductible temporary differences are utilised when their reversal results in deductions that are offset against taxable profits of future periods; and

(b) economic benefits in the form of reductions in tax payments will flow to the entity only if it earns sufficient taxable profits against which the deductions are offset.

BC17 The Board noted that:

(a) tax law determines which deductions are offset in determining taxable profits. It also noted that paragraph 5 of IAS 12 defines taxable profit as the profit of a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable.

(b) no deferred tax asset is recognised if the reversal of the deductible temporary difference will not lead to reductions in tax payments. Consequently, if tax law offsets different types of expenses against the same type of taxable income, an entity will need to assess, in a combination with all temporary differences, that, when they reverse, they will give rise to deductions against the same type of taxable income. Only such a combined assessment determines whether taxable profits are sufficient to utilise deductible temporary differences.

BC18 Consequently, if tax law, as is often the case, offsets a deduction against taxable income on an entity basis, without segregating deductions from different sources, an entity carries out a combined assessment of all its deferred tax assets relating to the same taxation authority and the same taxable entity. However, if tax law offsets specific types of loss (for example, capital losses) only against a particular type of income (for example, capital gains), an entity assesses a deferred tax asset in combination with other deferred tax assets of the same type, but separately from other deferred tax assets.

Structure of the amendment to IAS 12

BC19 During its work on the issue, the Interpretations Committee observed that the principles in IAS 12 that have to be applied in accounting for deferred tax assets for unrealised losses on debt instruments measured at fair value are clear (with one exception). The main reason for the diversity in practice is rather uncertainty about the application of some of these principles in IAS 12 in accounting for deferred tax assets for unrealised losses on debt instruments measured at fair value.

BC20 Consequently, the Board decided to add an illustrative example that would illustrate the application of the principle in IAS 12 in accounting for deferred tax assets for unrealised losses on debt instruments measured at fair value.

BC21 Moreover, the Board noted that a clarification of taxable profit against which deductible temporary differences are assessed for utilisation is needed and decided to amend paragraph 29 of IAS 12, as specified in paragraphs BC13 and BC15.

Illustrative computations and presentation

Extracts from statements of financial position and statements of comprehensive income are provided to show the effects on these financial statements on the transactions described below. These extracts do not necessarily conform with all the disclosure and presentation requirements of other Standards.

All the examples below assume that the entities concerned have no transactions other than those described.

After Example 6 — Replacement awards in a business combination, Example 7—Debt instruments measured at fair value is added.

Example 7—Debt instruments measured at fair value

Debt instruments

On 31 December 2X15, Entity Z holds a portfolio of three different types of debt instrument:

	31 December 2X15		
Debt instruments	**Type A**	**Type B**	**Type C**
Cost	2,000,000	1,000,000	4,000,000
Fair value on 31 December 2X15	1,740,000	1,173,179	3,826,821
Contractual interest rate in per cent	2.00	9.00	4.00

Entity Z acquired all the debt instruments on issuance for their nominal value. The issuer repays the nominal value of the debt instruments on their maturity on 31 December 2X20.

Interest is paid at the end of each year at the contractually fixed rate, which equalled the market interest rate when the debt instruments were issued. At the end of 2X15, the market interest rate is 5 per cent, which results in unrealised gains and losses on the debt instruments.

The shortfall on the debt instruments Types A and C is solely due to the difference between the contractual interest rate and the market interest rate on 31 December 2X15, ie Entity Z does not consider the debt instruments to be impaired.

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The debt instruments of the portfolio are held in a business model in which assets are managed both in order to collect contractual cash flows and for sale, and are classified in the 'fair value through other comprehensive income' category ('FVOCI debt instruments'). Consequently, gains and losses are recognised in other comprehensive income, except for impairment losses and foreign exchange gains and losses, until the financial asset is derecognised or reclassified out of the FVOCI category.

IAS 39

The debt instruments of the portfolio are classified as available-for-sale financial assets ('AFS debt instruments'). Consequently, they are measured at fair value after initial recognition (see paragraph 46 of IAS 39) with gains and losses recognised in other comprehensive income, except for impairment losses and foreign exchange gains and losses, until the financial assets are derecognised (see paragraph 55(b) of IAS 39).

At the end of 2X15, Entity Z expects that it will recover the carrying amounts of the debt instruments Types A and B through use, ie by holding them until maturity and collecting all of the contractual cash flows. In addition, it expects to recover the carrying amount of the debt instruments Type C by sale at the beginning of 2X16 for their fair value of CU3,826,821.

Tax law

The tax base of the debt instruments is amortised cost. Tax law does not allow Entity Z to deduct the losses on the debt instruments until they are realised, ie by selling the debt instruments or by failure of the issuer to make the contractual payments. The criteria for recognising impairment losses for tax purposes are not met. Similarly, gains on the debt instruments are not taxable until realised.

Tax law distinguishes ordinary gains and losses from capital gains and losses. Ordinary losses can be offset against both ordinary gains and capital gains. Capital losses can only be offset against capital gains. Capital losses can be carried forward for 5 years and ordinary losses can be carried forward for 20 years.

Ordinary gains are taxed at 30 per cent and capital gains are taxed at 10 per cent.

Tax law classifies interest income from the debt instruments as 'ordinary' and gains and losses arising on the sale of the debt instruments as 'capital'.

General

At the end of 2X15, Entity Z expects to file an ordinary tax loss of CU100,000 for the year 2X20.

From other sources, Entity Z has:

(a) taxable temporary differences of CU50.000, for which the deferred tax liabilities are recognised in profit or loss; and
(b) deductible temporary differences of CU300,000, for which the deferred tax assets would be recognised in profit or loss if they can be utilised.

The tax consequences resulting from the reversal of the temporary differences are included in ordinary taxable profit (or ordinary tax loss) of the period.

Except for the information given in the previous paragraphs, Entity Z has nothing in 2X01–2X20 that is relevant to its accounting for deferred taxes.

Temporary differences

At the end of 2X15, Entity Z identifies the following temporary differences:

	31 December 2X15			
	Type A	**Type B**	**Type C**	**Other sources**
Carrying amounts	1,740,231	1,173,179	3,826,821	Not specified
Tax bases	2,000,000	1,000,000	4,000,000	Not specified
Taxable temporary differences		173,179		50,000
Deductible temporary differences	259,769		173,179	300,000

The difference between the carrying amount of the debt instruments of Type A in Entity Z's statement of financial position of CU1,740,231 and their tax base of CU2,000,000 gives rise to a deductible temporary difference of CU259,769 on 31 December 2X15 (see paragraphs 20 and 26(d) of IAS 12). Entity Z expects to recover the carrying amount the debt instruments of Type A by holding them until maturity and collecting all the contractual cash flows. Consequently, the temporary difference will result in an amount that is deductible in determining taxable profit (or tax loss) of future periods when the carrying amount of the debt instruments is recovered. This is because Entity Z will deduct the tax base of CU2,000,000 against the inflow of taxable economic benefits of CU2,000,000 in the form of the repayment of the principal (CU2,000,000) and the interest payment of CU40,000 for the year 2X20.

Utilisation of deductible temporary differences

With some exceptions, deferred tax assets arising from deductible temporary differences are recognised to the extent that sufficient future taxable profits will be available against which the deductible temporary differences are utilised (see paragraph 24 of IAS 12).

Paragraphs 28–29 of IAS 12 identify three sources of taxable profits against which an entity can utilise deductible temporary differences. They are:

(a) future reversal of existing taxable temporary differences;
(b) future taxable profits; and
(c) tax planning opportunities.

Deferred tax assets arising from deductible temporary differences are recognised only to the extent that it is probable that at least one of these sources of taxable profits is available. Otherwise, no deferred tax asset is recognised.

Paragraphs 28–29 of IAS 12 thereby require an assessment of the utilisation of deferred tax assets arising from deductible temporary differences in two successive steps:

(a) an entity assesses in a first step (Step 1) whether there are sufficient taxable temporary differences relating to the same taxation authority and the same taxable entity which are expected to reverse:
  (i) in the same period as the expected reversal of the deductible temporary difference; or
  (ii) in periods into which a tax loss arising from the deferred tax asset can be carried back or forward; and
(b) if the assessment in Step 1 does not result in the recognition of all deferred tax assets arising from deductible temporary differences, the entity assesses in a second step (Step 2) whether:
  (i) 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); or
  (ii) tax planning opportunities are available to the entity that will create taxable profit in appropriate periods.

The deductible temporary difference of CU173,179 that arises from the debt instruments of Type C is assessed separately for utilisation whereas the other deductible temporary differences are assessed in combination with each other for utilisation. This is because tax law classifies the expected loss resulting from recovering the carrying amount of the debt instruments of Type C by sale as 'capital' and allows capital losses to be offset only against capital gains. It is Entity Z's only deductible temporary difference for which tax law classifies the related tax deductions as 'capital'.

The separate assessment results in not recognising a deferred tax asset for the deductible temporary difference that arises from the debt instruments of Type C, because Entity Z has no source of taxable profit available that tax law classifies a capital gain.

The deductible temporary difference of CU259,769 that arises from the debt instruments of Type C and the deductible temporary differences of CU300,000 arising from other sources are instead assessed for utilisation in combination with each other for utilisation. This is because their related tax deductions are classified as 'ordinary' by tax law. Entity Z expects to recover the carrying amounts of the debt instruments of Type A by use, ie holding them until maturity and collecting all of the contractual cash flows, and tax law classifies interest income from the debt instruments as 'ordinary'.

This classification of the tax deductions represented by the deductible temporary differences related to debt instruments of Type A as 'ordinary' follows from the fact that these deductible temporary differences reverse through the passage of time and interest income is classified as capital by tax law.

Utilisation of deductible temporary differences for which tax law classifies the related tax deductions as ordinary

	Deductible temporary differences	Source of taxable profits	Utilisation

Utilisation of deductible temporary differences for which tax law classifies the related tax deductions as ordinary

	Deductible temporary differences	Source of taxable profits	Utilisation
Type A	259,769		
Other sources	300,000		
Total deductible temporary differences	559,769		
Probable future tax loss in 2X20		(100,000)	
Excluding tax deductions from deductible temporary differences		559,769	–
Adjusted taxable profit (tax loss) for assessing utilisation of deductible temporary differences		459,769	
Utilisation	559,769	459,769	459,768

The utilisation of deductible temporary differences is not assessed against probable future taxable profit for a period upon which income taxes are payable (see paragraph 5 of IAS 12). The utilisation of deductible temporary differences is assessed against probable future taxable profit that excludes tax deductions resulting from the reversal of deductible temporary differences (see paragraph 29(a) of IAS 12).

In this example, Entity Z can limit its assessment of the utilisation of deductible temporary differences to probable future taxable profit that excludes tax deductions resulting from the reversal of deductible temporary differences (see paragraph 29(a) of IAS 12). Entity Z does not need to assess separately and in a first step the utilisation of deductible temporary differences against the future reversal of existing taxable temporary differences first (paragraphs 28 of IAS 12). This is because the probable future taxable profit that excludes tax deductions resulting from the reversal of deductible temporary differences is CU459,769 and therefore higher than the amount of taxable temporary differences of CU223,179 (CU173,179 + CU50,000).

Measurement of deferred tax assets and deferred tax liabilities

On the basis of these conclusions, Entity Z presents the following deferred tax assets and deferred tax liabilities in its financial statements on 31 December 2X14 and 31 December 2X15:

31 December 2X15

	Taxable temporary differences	Deductible temporary differences	Tax rate	Deferred tax liabilities	Deferred tax assets
Total taxable temporary differences	223,179	–	30%	66,954	

31 December 2X15

	Taxable temporary differences	Deductible temporary differences	Tax rate	Deferred tax liabilities	Deferred tax assets
Total utilisable deductible temporary differences	–	459,769	30%		137,931
Total				66,954	137,931

Allocation of changes in deferred tax assets between profit or loss and other comprehensive income

Changes in deferred tax assets that arise from items that are recognised in profit or loss are recognised in profit or loss (see paragraph 58 of IAS 12). Changes in deferred tax assets that arise from items that are recognised in other comprehensive income are recognised in other comprehensive income (see paragraph 61A of IAS 12).

Entity Z did not recognise deferred tax assets for all of its deductible temporary differences on 31 December 2015, and according to tax law all the tax deductions represented by the deductible temporary differences contribute equally to the tax loss for the period. Consequently, the assessment of the utilisation of deductible temporary differences does not specify whether the taxable profits are utilised for deferred tax items that are recognised in profit or loss (ie the deductible temporary differences from other sources) or deferred tax items that are recognised in other comprehensive income (ie the deductible temporary differences related to debt instruments).

For such situations, paragraph 63 of IAS 12 requires the changes in deferred taxes to be allocated to profit or loss and other comprehensive income on a reasonable pro rata basis.