STAFF PAPER

May 2014

IASB Meeting

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

Project	**Recognition of Deferred Tax Assets for Unrealised Losses (Proposed amendments to IAS 12)**
Paper topic	Main Staff Paper—The issue, project summary and recommendation of the IFRS Interpretations Committee

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Introduction

1. At its meeting in December 2012, the IASB tentatively decided that the accounting for deferred tax assets for unrealised losses on debt instruments measured at fair value should be clarified by a separate narrow-scope amendment to IAS 12 *Income Taxes*.[1] The IASB asked the IFRS Interpretations Committee (the ‘Interpretations Committee’) to develop a recommendation for this amendment.

Objective of Staff Papers 12–12C

2. The objective of Staff Papers 12–12C is to present the Interpretations Committee’s recommendations and analysis and to ask the IASB if it agrees. If the IASB agrees, the next step would be to publish an Exposure Draft for the proposed amendments.

Structure of Staff Papers 12–12C

3. This main Staff Paper therefore:

[1] http://media.ifrs.org/2012/Updates/IASB-Update-December-2012.pdf

(a) outlines the issue raised with the Interpretations Committee;

(b) outlines the recommendation of the Interpretations Committee and the aspects that the amendments to IAS 12 should address;

(c) outlines the Interpretations Committee's consideration of the FASB proposals; and

(d) asks questions to the IASB.

4. Staff Paper 12A illustrates the accounting for deferred tax assets for unrealised losses on debt instruments measured at fair value that reflects the recommendation of the Interpretations Committee.

5. Staff Paper 12A also provides a second illustration, for comparison purposes, that uses an approach designed to give a consistent outcome as that proposed recently by the US national standard-setter, the Financial Accounting Standards Board (FASB). This alternative approach is not recommended by the Interpretations Committee.

6. Staff Paper 12B summarises the discussions that the Interpretations Committee had on the relevant aspects of IAS 12 and its conclusions on these aspects. The paper is intended to aid the understanding of the Interpretations Committee's conclusions. It does not ask any further questions to the IASB.

7. Staff Paper 12C summarises the discussions of the Interpretations Committee on the alternative approach designed to give an outcome consistent with the FASB proposals. This paper explains the reasons why the Interpretations Committee does not recommend this approach.

8. These Staff Papers do not include a draft amendment to IAS 12. At present, we are developing the wording for such an amendment in discussions with the Interpretations Committee.

The issue

9. The issue is about how to determine the amount of deferred tax assets to recognise in respect of unrealised losses on debt instruments that are measured at fair value through other comprehensive income (OCI) in circumstances in which:

(a) fluctuations in the market interest rate result in unrealised losses on the debt instruments because the fair value is less than cost;

(b) the debt instruments are not impaired;

(c) the tax base of the debt instruments remains at cost until the losses are realised;

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

(e) the debt instrument holder has insufficient probable future taxable profits, against which it can utilise those losses.

10. The issue would arise, for example, when an entity that files tax losses acquires a 5-year fixed rate bond that is issued at the prevailing market interest, and when subsequently the market rate of interest increases; in this circumstance the fair value of the debt instrument would fall in response to the increase in the market interest rate.

11. The issue had initially been considered as part of an Annual Improvement,[2] but based on the comment letters received, the IASB decided that addressing the issue would require a narrow-scope amendment instead.[3]

12. The questions raised by this issue, that have been considered by the Interpretations Committee and that are addressed by their recommendation are:

(a) Does an unrealised loss on a debt instrument measured at fair value give rise to a deductible temporary difference, 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?

(b) Does an entity assess the utilisation of deductible temporary differences related to unrealised losses on debt instruments measured at fair value separately, or in combination with other deductible temporary differences?

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

[3] http://media.ifrs.org/2012/Updates/IASB-Update-December-2012.pdf

(c) Does an entity assume that it will recover an asset for more than its carrying amount when estimating probable future taxable profits? This issue is relevant if taxable profits from other sources than the debt instruments themselves are insufficient for the utilisation of deductible temporary differences.

(d) Does probable future taxable profit against which existing deductible temporary differences are assessed for utilisation include or exclude the tax deductions represented by those deductible temporary differences?

13. At the time that the IASB decided that a narrow-scope project was needed, the FASB was about to expose proposals[4] on the accounting for deferred tax assets for similar instruments as part of its financial instruments project. A key feature of the FASB proposals was to require that the realisation of deferred tax assets related to debt instruments measured at fair value through OCI is assessed separately from the realisation of other deferred tax assets; this approach is a different approach from that required in IAS 12. The IASB asked the Interpretations Committee to also consider whether a narrow-scope amendment to IAS 12 should achieve an outcome that is consistent with the one that has been proposed by the FASB for similar instruments?

Recommendation of the Interpretations Committee

14. The Interpretations Committee discussed this issue at three meetings. At its meeting in March 2014, it decided to recommend to the IASB proposed amendments to IAS 12 that mainly consist of an illustrative example that explains the following aspects of the application of the existing principles in IAS 12:[5]

(a) an unrealised loss on a debt instrument measured at fair value gives rise to a deductible temporary difference even if the debt instrument holder expects to recover its carrying amount by holding it to maturity and collecting all of

[4] The FASB proposed in its 'Proposed Accounting Standards Update—*Financial Instruments—Overall (Subtopic 825–10): Recognition and Measurement of Financial Assets and Financial Liabilities* (FASB's ED 2013) a separate assessment of whether a valuation allowance is needed for deferred tax assets related to debt instruments classified and measured at FV through other comprehensive income (FVOCI debt instruments).

[5] http://media.ifrs.org/2014/IFRIC/March/IFRIC-Update-March-2014.pdf

the contractual cash flows, and if the loss is not tax-deductible until realised (see paragraphs 20 and 26(d) of IAS 12). For details on the Interpretations Committee’s discussions, see paragraphs 4–12 of Staff Paper 12B.

(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 (see paragraph 24 of IAS 12). If tax law, however, restricts the utilisation of deductible temporary differences so that an entity can only utilise certain tax deductions against the taxable profits of a specific type (for example, if capital losses are deductible only against capital gains), the entity still assesses utilisation of such deductible temporary differences in combination with other deductible temporary differences, but only of the appropriate type (see paragraph 27 of IAS 12). For details on the Interpretations Committee’s discussions, see paragraphs 36–41 of Staff Paper 12B.

(c) when assessing the probability that future taxable profit will be available for the purpose of recognising deferred tax assets, an entity’s estimate of future taxable profit assumes that it will recover an asset for more than its carrying amount, provided that such a recovery is probable (see the objective and paragraph 29 of IAS 12). For details on the Interpretations Committee’s discussions, see paragraphs 13–24 of Staff Paper 12B.

(d) probable future taxable profit against which existing deductible temporary differences are assessed for utilisation excludes the tax deductions represented by those deductible temporary differences (see paragraphs 5 and 29 of IAS 12). For details on the Interpretations Committee’s discussions, see paragraphs 25–35 of Staff Paper 12B.

(e) the example should illustrate the assessment of the utilisation of deductible temporary differences when all three sources of taxable profits (ie future reversal of existing taxable temporary differences, future taxable profit and tax planning opportunities) are available but are insufficient in total to support the recognition of deferred tax assets for all of the deductible temporary differences (see paragraphs 24–31 of IAS 12).

(f) As a consequence of (e), the example should explain how an entity should determine the amount of deferred tax to recognise in OCI, compared to the amount that it should recognise in profit or loss, when the entity cannot recognise all deferred tax assets because it has insufficient future taxable profits. The Interpretations Committee noted that this determination should be on a reasonable pro-rata allocation, unless tax law requires a different allocation (see paragraph 63 of IAS 12).

15. The Interpretations Committee recommended that the illustrative example should explain the application of IAS 12 to debt instruments measured at fair value in accordance with IAS 39 as well as those measured at fair value in accordance with IFRS 9 *Financial Instruments*.

16. The Interpretations Committee recommendation also includes an amendment to paragraphs 24–31 of IAS 12 that would clarify item (d) in paragraph 14.

17. In summary, the recommendation of the Interpretations Committee reflects the approach that deferred tax assets for unrealised losses on debt instruments that are measured at fair value are recognised unless the entity is 'in a tax loss position'. 'In a tax loss position' means that the entity has insufficient probable future taxable profits to recognise deferred tax assets for all deductible temporary differences. In such a situation, the entity only recognises deferred tax assets for unrealised losses on debt instruments measured at fair value to the extent that it can utilise the related deductible temporary differences (see paragraph 24–31 of IAS 12).

18. It is the Interpretations Committee's view and the staff's view that this approach is based on the existing principles in IAS 12. Consequently, the proposed amendment is a clarification of IAS 12, rather than a change to its requirements.

19. The application of this approach is illustrated in paragraphs 18–36 of Staff Paper 12A.

Consideration of the FASB proposals

20. The Interpretations Committee considered whether a narrow-scope amendment to IAS 12 should achieve an outcome that is consistent with the one that had been proposed by the FASB for similar instruments.

21. As noted above, a key feature of the FASB proposals was to require that the realisation of deferred tax assets related to debt instruments measured at fair value through OCI is assessed separately from the realisation of other deferred tax assets. This is different from the requirements of IAS 12 and consequently the approach that is recommended by the Interpretations Committee leads to different results from the FASB proposals for entities that are 'in a tax loss position':

(a) in applying the approach that is recommended by the Interpretations Committee, the entity 'in a tax loss position' recognises deferred tax assets for unrealised losses on debt instruments measured at fair value only to the extent that the sources of taxable profits that are identified in paragraphs 28–29 of IAS 12 are available for the utilisation of the related deductible temporary differences.

(b) if IAS 12 was amended to require a separate assessment of deferred tax assets for debt instruments measured at fair value through OCI, deferred tax assets would be recognised for all of the deductible temporary differences related to unrealised losses on debt instruments measured at fair value, even if the entity is 'in a tax loss position'. They are recognised if the unrealised loss has been recognised in OCI and it is expected that the unrealised loss will reverse in OCI, because of the holder's ability and intention to hold the debt instrument until the unrealised loss reverses.

22. The main reason that the Interpretations Committee did not recommend that IAS 12 be further amended to achieve a consistent outcome to the approach proposed by the FASB is because it is not clear to the Interpretations Committee what the economic benefit embodied in the additional amounts of deferred tax assets is that are recognised in applying this alternative approach. This additional amount is the difference between the amount of deferred tax assets that is recognised in applying the approach by proposed by the FASB (which includes all of the deferred tax assets related to unrealised losses on debt instruments measured at fair value through OCI) and the amount of deferred tax assets that is recognise in applying the Interpretations Committee's recommended approach.

23. It appeared to the Interpretations Committee that the additional amount of deferred tax assets does not represent probable reductions of future tax payments (ie the economic

benefit embodied in deferred tax assets) but the avoidance of higher tax losses, if the entity is ‘in a tax loss position’.

24. The application of a further amendment to IAS 12 intended to achieve a consistent outcome to the approach proposed by the FASB is illustrated in paragraphs 37–41 of Staff Paper 12A.

Questions for the IASB

Questions for the IASB
1. Do the IASB members have any questions on the discussions and recommendation of the Interpretations Committee? 2. Does the IASB agree with the Interpretations Committee’s conclusions and recommendation?