STAFF PAPER

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IASB Meeting

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Project	**Recognition of Deferred Tax Assets for Unrealised Losses (Proposed amendments to IAS 12)**		
Paper topic	Appendix A—Illustrative Examples		
CONTACT	Thomas Harzheim	tharzheim@ifrs.org	+44 (0)20 7246 0552

Purpose of Appendix A

1. The purpose of Appendix A is to illustrate the application of the approach that is recommended by the IFRS Interpretations Committee (the 'Interpretations Committee') (see paragraphs 14–19 of Staff Paper 12) and the consistent outcome approach (see paragraphs 20–24 of Staff Paper 12) by an example. The consistent outcome approach is an alternative approach considered by the Interpretations Committee in order to achieve an outcome that would be consistent with the proposals by the FASB for determining the deferred tax for similar instruments. Having considered the consistent outcome approach, the Interpretations Committee does not recommend it to the IASB for the reasons explained in Staff Papers 12 and 12C.

2. In addition, Appendix A summarises and compares the results from the application of both approaches.

Fact pattern

Debt instruments

3. On 31 December 2X15, Entity Z holds a portfolio of three debt instruments:

Debt instrument	31 December 2X15 A	B	C
Cost	2,000,000	1,000,000	4,000,000
Fair value on 31 December 2X15	1,740,231	1,173,179	3,653,642
Contractual interest rate in per cent	2.00	9.00	4.00

4. 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.

5. 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.

6. The shortfall on Debt Instruments 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 Debt Instruments A and C to be impaired.

7. 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 *Financial Instruments: Recognition and Measurement*) 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).

8. At the end of 2X15, Entity Z expects that it will recover the carrying amounts of Debt Instruments 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 Debt Instrument C by sale at the beginning of 2X16 for CU3,653,642,[1] which is assumed to be its fair value on 31 December 2X15.

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

Tax law

9. The tax base of the debt instruments is amortised cost, which tax law allows to be offset either against the repayment of the principals on maturity or against the sale proceeds when the debt instruments are sold. Consequently, 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 repay the principal on maturity. Furthermore, the tax base of the debt instruments might be reduced by the deduction of impairment losses. However, the criteria for recognising impairment losses for tax purposes are not met in the case of Debt Instruments A and C. Similarly, gains on the debt instruments are not taxable until realised.

10. 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.

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

12. 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

13. On 31 December 2X15, Entity Z has, from other sources:

    (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.

14. The tax consequences resulting from the reversal of the temporary differences will be included in ordinary taxable profit (or ordinary tax loss) of the period 2X20.

15. At the end of 2X15, Entity Z expects to file an ordinary tax loss of CU300,000 for the year 2X20. This tax loss includes all the amounts that will be taxable or tax deductible on the reversal of the related temporary differences and that are classified as ordinary by tax law.

16. Entity Z has no capital gains against which it can utilise capital losses arising in years 2X15–2X20.

17. Except for the information given in the previous paragraphs, Entity Z has no gains, losses or transactions in 2X01–2X20 that are relevant to its accounting for deferred taxes.

Analysis—Approach recommended by the Interpretations Committee

Temporary differences

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

	31 December 2X15			
Debt instruments	**A**	**B**	**C**	**Other sources**
Carrying amounts	1,740,231	1,173,179	3,653,642	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		346,358	300,000

Debt Instrument A

19. The difference between the carrying amount of Debt Instrument A in Entity Z's statement of financial position of CU1,740,231 and its 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 *Income Taxes*). This is because deductible temporary differences are temporary differences between the carrying amount of an asset or a liability in the statement of financial position and its tax base that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods, when the carrying amount of the asset or the liability is recovered or settled (see paragraph 5 of IAS 12).

20. Entity A expects to hold Debt Instrument A to maturity and collect all the contractual cash flows. Consequently, the temporary difference between the carrying amount of Debt Instrument A in Entity Z's statement of financial position of CU1,740,231 and its tax base of CU2,000,000 will reverse until maturity, while Entity Z recovers the carrying amount of Debt Instrument A by collecting interest payments of CU40,000 each year until maturity and the repayment of the principal of CU2,000,000 on maturity on 31 December 2X20. If the market interest rate remains constant at 5 per cent between 31 December 2X15 and 31 December 2X20 and the other relevant assumption remains unchanged as well, the deductible temporary difference reverses progressively from 31 December 2X15 to 31 December 2X20 as the discount unwinds as follows:

			Year		
	2X16	**2X17**	**2X18**	**2X19**	**2X20**
Carrying amount at the beginning of the year (1 January)	1,740,231	1,787,243	1,836,605	1,888,435	1,942,857
Unwind of discount	47,012	49,362	51,830	54,422	57,143
Carrying amount at the end of the year (31 December)	1,787,243	1,836,605	1,888,435	1,942,857	2,000,000

21. Furthermore, the difference between the carrying amount of Debt Instrument A in Entity Z's statement of financial position of CU1,740,231 and its tax base of CU2,000,000 results in an amount that will be deducted in determining taxable profit (tax loss) of 2X20 when the entire tax base of CU2,000,000 is offset against the taxable economic benefits of 2X20, including the repayment of the principal.

Utilisation of deductible temporary differences

22. 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).

23. 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 profit; and

(c) tax planning opportunities.

24. 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.

25. 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 that are expected to reverse:

(i) in the same period as the expected reversal of the deductible temporary differences; or

(ii) in periods into which tax losses arising from the deferred tax assets 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 differences (or in the periods into which tax losses arising from the deferred tax assets can be carried back or forward); or

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

26. The deductible temporary difference of CU346,358 that arises from Debt Instrument C is assessed separately for utilisation, whereas the other deductible temporary differences are assessed in combination with one another for utilisation. This is because tax law classifies the expected loss resulting from recovering the

carrying amount of Debt Instrument C by sale as ‘capital’ and allows capital losses to be offset only against capital gains. This is the only one of Entity Z’s deductible temporary differences for which tax law classifies the related tax deductions as capital.

27. The separate assessment results in not recognising a deferred tax asset for the deductible temporary difference that arises from Debt Instrument C, because Entity Z has no source of taxable profits available that tax law classifies as capital gain.

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

29. The classification of the tax deductions represented by the deductible temporary differences related to Debt Instrument A as ordinary follows from the fact that these deductible temporary differences reverse through the passage of time and interest income is classified as ordinary by tax law.

30. Although the deductible temporary difference of CU259,769 related to Debt Instrument A reverses over the period to maturity, the total amount is included in the utilisation assessment of 2X20, because the entire tax base of CU2,000,000 of Debt Instrument A is deducted on maturity in 2X20 for tax purposes.

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

	Deductible temporary differences	Source of taxable profits	Utilisation
Step 1 – assess utilisation against taxable temporary differences		*taxable temporary differences*	
Debt Instrument A	259,769		
Debt Instrument B		173,179	
Deductible temporary differences from other sources	300,000		
Other sources		50,000	
Total utilisation because of taxable temporary differences	**559,769**	**223,179**	**223,179**
Step 2 – assess utilisation against probable future taxable profits		*Future taxable profit*	
Total deductible temporary differences	559,769		
Utilisation because of taxable temporary differences (Step 1)	(223,179)		
Deductible temporary differences requiring further assessment of utilisation	336,590		
Probable future tax loss in 2X20		(300,000)	
Taxable profits already considered as part of Step 1		(223,179)	
Excluding tax deductions from deductible temporary differences		559,769	–

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

	Deductible temporary differences	Source of taxable profits	Utilisation
Adjusted taxable profit (tax loss) for assessing utilisation of deductible temporary differences		36,590	
Total utilisation because of future taxable profit	**336,590**	**36,590**	**36,590**
Total utilisation (Step 1 + Step 2)			**259,769**

31. Taxable profit (tax loss) is the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable) (see paragraph 5 of IAS 12).

32. Taxable profit (tax loss) upon which income taxes are payable (recoverable) includes all taxable economic benefits and tax deductions of a period. Consequently, the probable future ordinary tax loss of Entity Z in 2X20 includes the taxable economic benefit of CU2,000,000 from the repayment of the principal of Debt Instrument A and the equivalent tax deduction, also CU2,000,000. It also includes the taxable amounts from recovering Debt Instrument B and the taxable amounts and the tax-deductible amounts for which temporary differences from other sources exist on 31 December 2X15. In other words, with the exception of tax deduction for which the deductible temporary difference related to Debt Instrument C exists, it includes all amounts for which temporary differences exist on 31 December 2X15.

33. The probable future ordinary tax loss of Entity Z in 2X20 includes the taxable economic benefit of CU2,000,000 from the repayment of the principal of Debt Instrument A, because it is probable that Entity Z will receive CU2,000,000 on maturity of Debt Instrument A as the repayment of the principal and will therefore recover the debt instrument for more than its carrying amount of CU1,740,231.

34. The utilisation of deductible temporary differences is not, however, 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 of CU36,590 (see paragraph 29(a) of IAS 12).

Measurement of deferred tax assets and deferred tax liabilities

35. 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 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	
Total utilisable deductible temporary differences	–	259,769	30%		77,931
Total				66,954	77,931

36. The deferred tax assets related to Debt Instruments A and B are measured using the tax rate for ordinary gains of 30 per cent, because that is the tax rate that applies to gains and losses resulting from recovering debt instruments by holding them to maturity and collecting all the contractual cash flows (see paragraph 51A of IAS 12).

Analysis—Consistent outcome approach

37. The consistent outcome approach is an alternative approach considered by the Interpretations Committee in order to achieve an outcome that would be consistent with the proposals by the FASB for determining the deferred tax for similar

instruments. Having considered the consistent outcome approach, the Interpretations Committee does not recommend it to the IASB.

Temporary differences

38. We refer to paragraphs 18–21 of this Staff Paper.

Utilisation of deductible temporary differences

39. When applying the consistent outcome approach, the utilisation assessment starts with the extra step of the separate assessment of the utilisation of deductible temporary differences related to debt instruments measured at fair value through OCI:

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

	Deductible temporary differences	Source of taxable profits	Utilisation
Step 0 – separate assessment of deductible temporary differences of debt instruments measured at fair value through OCI		*Separate assessment*	
Debt Instrument A	259,769		
Utilisation by ability and intention to hold Debt Instrument A until unrealised loss reverses		259,769	
Total utilisation because of separate assessment	**259,769**	**259,769**	**259,769**
Step 1 - assess utilisation against taxable temporary differences		*Taxable temporary differences*	
Debt Instrument A	259,769		
Debt Instrument B		173,179	
Deductible temporary differences from other	300,000		

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

	Deductible temporary differences	Source of taxable profits	Utilisation
sources			
Other sources		50,000	
Total deductible temporary differences	559,769		
Utilisation because of Step 0	(259,769)		
Deductible temporary differences requiring further assessment of utilisation	300,000		
Total utilisation because of taxable temporary differences	**300,000**	**223,179**	**223,179**

Step 2 - assess utilisation against probable future taxable profits		*Future taxable profit*	
Total deductible temporary differences	559,769		
Utilisation because of Step 0	(259,769)		
Utilisation because of taxable temporary differences (Step 1)	(223,179)		
Deductible temporary differences requiring further assessment of utilisation	76,821		
Probable future tax loss in 2X20		(300,000)	
Taxable profits already considered as part of Step 0		(259,769)	
Taxable profits already considered as part of Step 1		(223,179)	
Excluding tax deductions from deductible temporary differences		559,769	–

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

	Deductible temporary differences	Source of taxable profits	Utilisation
Adjusted taxable profit (tax loss) for assessing utilisation of deductible temporary differences		(223,179)	
Total utilisation because of future taxable profit	**76,821**	**–**	**–**
Total utilisation (Steps 0, 1 and 2)			**482,948**

40. Entity Z cannot utilise any deductible temporary differences on the basis of future taxable profit. This is because the adjusted taxable profit is a tax loss, ie Entity Z can utilise more deductible temporary differences against the other sources of taxable profits than it could against future taxable profit.

Measurement of deferred tax assets and deferred tax liabilities

41. 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 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	
Total utilisable deductible temporary differences	–	482,948	30%		144,884
Total				66,954	144,884

Comparison of results

42. The following table compares the results from the application of both approaches:

	31 December 20X5		
	Total deductible temporary differences	**Probable utilisation of deductible temporary differences**	**Deferred tax assets recognised**
Recommendation of the Interpretations Committee (existing principles in IAS 12)	559,769	259,769	77,931
Consistent outcome approach	559,769	482,948	144,884
Difference	**0**	**223,179**	**66,953**

43. The application of both approaches to one and the same fact patterns leads to significantly different results. The application of the consistent outcome approach increases the recognition of deferred tax assets by 85.9 per cent.