STAFF PAPER

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Project	**Recognition of Deferred Tax Assets for Unrealised Losses (Proposed amendments to IAS 12)**
Paper topic	Appendix B—Summary of discussions of the Interpretations Committee on aspects on IAS 12

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

Purpose of Appendix B

1. The purpose of Appendix B is to aid the understanding of the conclusions of the IFRS Interpretations Committee (the 'Interpretations Committee') on the relevant aspects of IAS 12 *Income Taxes* by providing further details on the discussions that the Interpretations Committee had. However, it does not ask any further questions to the IASB.

2. The aspects of the Interpretations Committee's considerations addressed are:

   (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 the contractual cash flows and if the loss is not tax deductible until realised (see paragraphs 20 and 26(d) of IAS 12).

   (b) 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).

(c) 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).

(d) 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 taxable profits of a specific type (for example, if capital losses are deductible only against capital gains), the entity still assesses the 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).

(e) the question of whether an action that results only in the reversal of existing deductible temporary differences qualifies as a tax planning opportunity is relevant to this assessment (see paragraph 30 of IAS 12).

3. In addition, this Staff Paper explains the general approach for the amendment to IAS 12 that the Interpretations Committee recommends.

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 the contractual cash flows and if the loss is not tax deductible until realised.

4. 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 may be illustrated by the following example:

Fact pattern:

Entity A invests at the beginning of Year 1 CU1,000[1] in a debt instrument with a nominal value of CU1,000 payable on maturity in 5 years.

Interest is paid at the end of each year at a rate of 2 per cent, taxable when received. The contractual interest rate of 2 per cent equals the market interest rate at the beginning and the end of Year 1. The market interest rate increases at the end of Year 2 to 5 per cent, which results in a fair value of the debt instrument at the end of Year 2 of CU918. The shortfall is solely due to the difference between the market interest rate and the nominal interest rate of the debt instrument, ie Entity A does not consider the debt instrument to be impaired.

The debt instrument is held in a business model in which assets are managed both in order to collect contractual cash flows and for sale and is classified in the 'fair value through other comprehensive income' category ('FVOCI debt instrument').

Tax law does not allow Entity A to deduct the loss until it is realised, ie by selling the debt instrument or by failure of the issuer to repay the principal.

5. In this example, the investor only pays taxes on the interest income if it holds the debt instrument until maturity. The repayment of the principal instead does not trigger any tax payments.

6. 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.

7. They think that the loss will not be realised if the entity has the ability and intention to hold the debt instrument until the unrealised loss reverses (which might be until maturity) and if it does not consider the debt instrument to be impaired. In other words, the entity expects to receive all the contractual cash flows or equal cash flows from third parties. Such losses reverse over the period to maturity merely by holding it.

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

8. The Interpretations Committee disagrees with the view that the repayment of the principal is a non-tax event. It thinks that an unrealised loss on a debt instrument measured at fair value gives rise to a deductible temporary difference, even if the holder of the debt instruments expects to hold the debt instrument to maturity and collect all the contractual cash flows. 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.

9. The tax base of the debt instrument is deducted against the inflow of taxable economic benefits resulting from the repayment of the principal. This may be illustrated by Entity A’s cash flows in Years 1–5:

Period	Transaction	CU
Year 1	Investment in the debt instrument at the beginning of Year 1	-1,000
Year 1	Interest income received at the end of Year 1	20
Year 2	Interest income received at the end of Year 2	20
Year 3	Interest income received at the end of Year 3	20
Year 4	Interest income received at the end of Year 4	20
Year 5	Interest income and repayment of principal received at the end of Year 5	1,020

10. This would have the following tax effect in Year 5:

	CU
Economic benefit that will flow to Entity A in Year 5 (repayment of principal + interest for Year 5)	1,020
Less tax base	-1,000
Future taxable profit in Year 5	20

11. The fact that the repayment of the principal does not affect the taxable profit that is filed for tax purposes is because the tax base equals the inflow of the taxable economic benefits resulting from the repayment of the principal.

12. 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 for its lower fair value (for example, CU918) and holds it to maturity has to pay taxes on a gain of CU82, whereas the entity in the example will not pay any taxes because of the repayment of the principal that would otherwise be due.

When assessing the probability that future taxable profits 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 such a recovery is probable.

13. 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.

14. Although this guidance does not make reference to the carrying amount of assets within 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 that, for one and the same asset:

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

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

15. Consequently, proponents of this view think that an entity cannot assume that it will collect the entire principal of CU1,000 in the example above. Instead they think it

must assume that it will collect only the part of the principal that equals the carrying amount of the asset, ie fair value.

16. The Interpretations Committee, however, is of the view 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 (determining temporary differences).

17. The Interpretations Committee thinks that its view aligns with the concept given in paragraph 24 of IAS 12, provided that such a gain is probable. Paragraph 24 of IAS 12 requires the assessment of the recognition of deferred tax assets on the basis of probable future taxable profits.

18. Estimating probable future taxable profits, however, implies considering events that take place after the balance sheet date, including the realisation of profits from recovering the carrying amount of an asset.

19. The Interpretations Committee does not think that the balance sheet liability method, which focuses on temporary differences, requires an entity to assume that an asset is recovered only for its carrying amount in estimating probable future taxable profits.

20. The balance sheet method, which focuses on temporary differences, is the method required by IAS 12 (see paragraph IN2 of IAS 12) and is the basis for the inherent assumption of recovering an asset for its carrying amount. This method focuses on the difference between the carrying amount of an asset or a liability in the statement of financial position and its tax base at the balance sheet date. By doing so, it determines and limits the tax effects that an entity accounts for. It does not, however, indicate the conditions that will prevail when the temporary differences reverse and what tax consequences these reversals will have.

21. The conditions that will prevail when the temporary difference reverses, and the tax consequences that this reversal will have, are instead determined by the reporting entity’s estimate of the future situation on the basis of tax law and other principles in IAS 12. These include the principle in paragraph 51 of IAS 12 that the measurement of deferred tax liabilities and deferred tax assets shall reflect the tax consequences that

would follow from the manner in which the entity expects, at the end of the reporting period, to recover or settle the carrying amount of its assets and liabilities.

22. Moreover, limiting the estimate of probable future taxable profit against which deductible temporary differences are assessed for utilisation to the carrying amount of assets could lead to inappropriate results in many cases. This is because for the purposes of consistency, the limitation on the estimate of probable future taxable profits against which deductible temporary differences are assessed for utilisation by the carrying amounts of the assets would not only apply to assets to which temporary differences are related. It would instead apply to all assets of the entity.

23. 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. Property, plant and equipment is very often measured after recognition using the cost model (see paragraph 30 of IAS 16 *Property, Plant and Equipment*) and inventories are measured at the lower of cost and net realisable value (see paragraph 9 of IAS 2 *Inventories*).

24. Consequently, the assumption of recovering these assets for only their carrying amount conflicts with an expectation that the entity will generate future taxable profit. This is because a significant part of the manufacturing entity's probable future taxable profit 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 is it possible to assume that the manufacturing entity will generate future taxable profit, and thus be able to recognise deferred tax assets.

Probable future taxable profit against which existing deductible temporary differences are assessed for utilisation excludes the tax deductions represented by those deductible temporary differences.

25. During its work on the issue, the Interpretations Committee observed uncertainty among stakeholders about how to define probable future taxable profit against which deductible temporary differences are assessed for utilisation in the case in which they seem to be insufficient for the recognition of all deferred tax assets. The uncertainty

is 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 those deductions.

26. Paragraph 29 of IAS 12 requires the assessment of deductible temporary differences against probable future *taxable profit* for utilisation when assessing the recognition of deferred tax assets.

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

28. Consequently, assessing the recognition of deferred tax assets on the basis of taxable profits, as defined in paragraph 5 of IAS 12 might result in double counting, because the *amount upon which income taxes are payable* might include tax deductions resulting from the reversal of deductible temporary differences.

Illustrative example

29. This may be illustrated by Example 1, which is presented in IAS 12 immediately following paragraph 8.

30. In that example, current liabilities include accrued expenses with a carrying amount of CU100. The related expense will be deducted for tax purposes in a future period on a cash basis. It is concluded in the example that the tax base of the accrued expenses is nil.

31. In order to recognise a deferred tax asset, the entity needs to assess whether it expects sufficient probable future taxable profits, against which the deductible temporary difference can be utilised in order to realise the economic benefit of the deferred tax asset.

32. Probable future taxable profit will include estimates of future taxable profit arising from the various activities of the entity.

33. However, the tax deduction resulting from the reversal of the deductible temporary difference related to the accrued expenses should be excluded from the estimate of the probable future taxable profit of the period when the deductible temporary difference reverses.

34. This is because without excluding the tax deduction resulting from the reversal of the deductible temporary difference from the taxable profit (ie adding this tax deduction back to taxable profit), the entity would need in the example above a taxable income of CU200 to offset a tax deduction of CU100, ie the deductible temporary difference would end up being double counted.

35. Consequently, the Interpretations Committee thinks 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.

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 an entity can only utilise certain tax deductions against 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.

36. The Interpretations Committee confirmed the proposal in the Exposure Draft *Annual Improvements to IFRSs 2010–2012 Cycle*[2] (the 'Annual Improvements ED') on this issue: an entity carries out a combined assessment of the utilisation of all deductible temporary differences relating to the same taxation authority and the same taxable entity, if tax law offsets all tax deductions of the entity against all of its taxable profits. As is often the case, tax law does not segregate deductions from different sources. 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 deductible temporary difference in combination with other deductible temporary differences of the appropriate type, but separately from other deductible temporary differences.

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

37. This because paragraph 24 of IAS 12 requires that deferred tax assets are recognised only to the extent that the probable future taxable profit of the appropriate type is available against which the deductible temporary differences can be utilised.

38. 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.

39. Consequently, tax law determines which deductions are offset in determining taxable profits, because 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.

40. No deferred tax asset, however, is recognised if the reversal of the deductible temporary difference will not lead to reductions in tax payments (see paragraphs 24 and 27 of IAS 12).

41. Consequently, if tax law offsets different types of expenses against the same type of taxable income, an entity will need to assess a combination of all temporary differences that, when they reverse, will give rise to deductions against the same type of taxable income. Only such a combined assessment can determine whether taxable profits are sufficient to utilise deductible temporary differences.

Consideration of whether an action that results only in the reversal of existing deductible temporary differences qualifies as a tax planning opportunity.

42. The Annual Improvements ED proposed to clarify that an action that results only in the reversal of existing deductible temporary differences is not a tax planning opportunity, as specified in paragraph 30 of IAS 12. To qualify as a tax planning opportunity, the action needs to create or increase taxable profit.

43. This proposed clarification responded to the view presented in the submission to the Interpretations Committee[3] that an entity's ability and intention to hold the AFS debt instruments until the unrealised losses, which have been recognised in other comprehensive income (OCI), reverse in OCI, is a source of taxable profits in terms of paragraph 24 of IAS 12.

44. On the basis of its analysis on the previous issues presented in this Staff Paper, however, the Interpretations Committee concluded that the question of whether holding a debt instrument measured at fair value until an unrealised loss reverses qualifies as a tax planning opportunity, or is at least akin to a tax planning opportunity, is not relevant for recognising deferred tax assets for unrealised losses on debt instruments measured at fair value.

45. An entity accounts for deferred tax assets related to unrealised losses on debt instruments measured at fair value comprehensively by applying the following two conclusions:

(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 the contractual cash flows and if the loss is not tax deductible until realised; and

(b) 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.

46. Because of these conclusions, an unrealised loss on a debt instrument measured at fair value always gives rise to a deductible temporary difference and the repayment of the (entire) principal is included in the estimate of future taxable profit (see paragraph 29 of IAS 12).

47. Consequently, by also assuming that holding a debt instrument measured at fair value until an unrealised loss reverses qualifies as a tax planning opportunity, or is at least

[3] http://www.ifrs.org/Meetings/Documents/IFRICMay2010/1005ap15obs.pdf

akin to a tax planning opportunity, an entity would account twice for the tax effects from an unrealised loss on a debt instrument measured at fair value. The same inflow of economic benefits would be included in the estimate of future taxable profit and would give rise to taxable profits from a tax planning opportunity.

General approach for the amendment

48. The Interpretations Committee recommends that the amendments to IAS 12 should mainly be an illustrative example, with other amendments to IAS 12 only being made if the clarification through an illustrative example is insufficient.

49. The Interpretations Committee reached this conclusion for the following reasons:

    (a) it thinks that the existing principles in IAS 12 result in an appropriate reflection of deferred tax assets for unrealised losses on debt instruments measured at fair value in the financial statements. Consequently, the purpose of the amendment to IAS 12 would not be to introduce new, or amend existing, principles into IAS 12, but instead to explain the application of the existing principles.

    (b) it understands from the analysis of the comment letters on the Annual Improvements ED and from discussions that there is, above all, uncertainty about the application of some of the principles in IAS 12. Most of the commentators on the Annual Improvements ED agreed with the general clarifications in the Annual Improvements ED that:

        (i) an entity assesses whether to recognise the tax effect of a deductible temporary difference as a deferred tax asset in combination with other deferred tax assets. If tax law restricts the utilisation of tax losses so that an entity can only deduct the tax losses against the income of a specific type (for example, if it can deduct capital losses only against capital gains), the entity must still assess a deferred tax asset in combination with other deferred tax assets, but only with deferred tax assets of the appropriate type.

(ii) taxable profit against which an entity assesses a deferred tax asset for recognition is the amount before any reversal of deductible temporary differences.

(iii) an action that results only in the reversal of existing deductible temporary differences is not a tax planning opportunity. To qualify as a tax planning opportunity, the action needs to create or increase taxable profit.

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

(c) furthermore, several commentators criticised the fact that the Annual Improvements ED proposed three general clarifications (see paragraph 49(b)) to specify the accounting in the very specific fact pattern that was raised with the Interpretations Committee (for the fact pattern see paragraph 9 of Staff Paper 12). Even commentators on the Annual Improvements ED who agreed with the three proposed clarifications were concerned about unintended consequences.

50. Considering these arguments, the Interpretations Committee thinks that the clarification of the accounting for deferred tax assets for unrealised losses on debt instruments measured at fair value should principally consist of an illustrative example. Such an illustrative example would address the issue raised with the Interpretations Committee by illustrating the application of IAS 12 on the basis of a scenario in which this issue is relevant in practice. The illustrative example would explain what aspects of IAS 12 are being applied and why. The aspects that the Interpretations Committee thinks need to be addressed in the illustrative example are listed in paragraph 14 of Staff Paper 12.

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

52. On this basis, the Interpretations Committee recommend only one amendment in addition to the illustrative example: the clarification to paragraph 29 of IAS 12 to reflect the difference between the taxable profit that is defined in paragraph 5 of IAS 12 and the taxable profit that is used to assess the utilisation of deductible temporary differences.