IFRS

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 C—Discussion of an approach that would achieve an accounting outcome that is consistent with the one that was recently proposed by the FASB

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Purpose of Appendix C

1. The purpose of Appendix C is to summarise the discussions of the IFRS Interpretations Committee (the ‘Interpretations Committee’) on an approach that would achieve an accounting outcome that is consistent with the one that was recently proposed by the US national standard-setter, the Financial Accounting Standards Board (FASB)—the consistent outcome approach—and explains the reasons why the Interpretations Committee does not recommend this approach.

2. At its meeting in December 2012, the IASB also asked the Interpretations Committee to analyse whether IAS 12 should be amended to achieve an outcome for deferred tax accounting that would be consistent with the one that was recently proposed by the FASB for the same type of debt instrument

3. This Staff Paper therefore:

   (a) outlines the proposal of the FASB;

   (b) outlines an approach that would achieve a consistent outcome in accounting for deferred taxes in applying IAS 12 (consistent outcome approach); and

(c) explains why the Interpretations Committee does not recommend such an approach to the IASB.

The FASB's proposal

4. On 14 February 2013, the FASB published the Proposed Accounting Standards Update—*Financial Instruments—Overall (Subtopic 825–10): Recognition and Measurement of Financial Assets and Financial Liabilities* (the 'FASB's 2013 ED').[1]

5. In paragraph 825-10-35-16 of the FASB's 2013 ED, it proposes that an entity should evaluate the need for a valuation allowance of deferred tax assets related to debt instruments classified and measured at fair value through other comprehensive income (FVOCI debt instruments) separately from its evaluation of other deferred tax assets.

6. This separate assessment does not by itself conclude on whether a valuation allowance is recognised on the deferred tax assets related to unrealised losses on FVOCI debt instruments.

7. The FASB explains in paragraph BC242 of its 2013 ED, however, that this proposal might result in providing no valuation allowance. We understand that no valuation allowance is provided if:

    (a) the recovery of the unrealised holding losses in other comprehensive income (OCI); and

    (b) the corresponding reversal of the deferred tax asset resulting from the entity's ability and intention to hold an investment in a debt instrument until the recovery of its amortised cost basis

    is viewed as being the realisation of its tax benefit (see paragraph BC240 of the FASB's 2013 ED).

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[1] http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175825999175&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=1363169&blobheadervalue1=filename%3DProposed_ASU_Financial_Instruments%25E2%2580%2594Overall_%2528Subtopic_825-10%2529_Recognition_and_Measurement.pdf&blobcol=urldata&blobtable=MungoBlobs

8. Applying this view in combination with the *separate assessment approach* may result in not recognising a valuation allowance on such deferred tax assets, even though the entity will not pay any taxes in any case. This is because the effect of the reversal of the deferred tax assets might be only to avoid higher tax losses.

Consistent outcome approach

9. The Interpretations Committee considered an approach to account for deferred tax assets for unrealised losses on debt instruments measured at fair value that would achieve an accounting outcome that would be consistent with the one that was recently proposed by the FASB. Such an approach would differ from the Interpretations Committee's recommendation in the assessment of the utilisation of deductible temporary differences.

10. To be consistent with the FASB's proposals, the utilisation of deductible temporary differences related to FVOCI debt instruments would be assessed separately from other deductible temporary differences as long as the unrealised losses are:

    (a) recognised in OCI; and

    (b) expected to reverse in OCI because of the entity's ability and intention to hold the debt instruments until the unrealised losses reverse.

11. The separate assessment would not apply if the (unrealised) losses are (expected) to be recognised in profit or loss.

12. The utilisation of these deductible temporary differences would result from:

    (a) the recovery of the unrealised holding losses in OCI; and

    (b) the corresponding reversals of the deferred tax assets resulting from the entity's intention and ability to hold an investment in debt instruments until recovery of their amortised cost bases.

13. This would be a new source of taxable profits in addition to the ones identified in paragraphs 28–29 of IAS 12.

14. For further details of the FASB's discussions and the analysis of the arguments in applying IAS 12, refer to paragraphs 54–104 of Staff Paper 12 presented at the May 2013 Interpretations Committee meeting.[2]

15. Consequently, the only difference between the approach that is recommended by the Interpretations Committee and the consistent outcome approach is the separate assessment of the utilisation of deductible temporary differences related to FVOCI debt instruments.

16. Both approaches result in the same accounting for deferred tax assets related to FVOCI debt instruments by entities that can demonstrate utilisation of all of their deductible temporary differences on the basis of the sources of taxable profits identified in paragraphs 28–29 of IAS 12. These are: future reversal of existing taxable temporary differences, future taxable profit or tax planning opportunities.

17. However, the two approaches lead to different accounting results by entities that cannot demonstrate utilisation of all of their deductible temporary differences on the basis of these sources of taxable profits, because the entity is 'in a tax loss position'. The consistent outcome approach leads to the recognition of additional deferred tax assets. In the illustrative example in Staff Paper 12A it results in the recognition of additional deferred tax assets in the amount of CU66,953 (see paragraph 42 of Staff Paper 12A).[3]

Reason for the Interpretations Committee preferring a different approach

18. The main reason for the Interpretations Committee not recommending the consistent outcome approach to the IASB was that it thinks that the additional deferred tax asset of CU66,953 in the illustrative example in Staff Paper 12A (see paragraph 42 of Staff Paper 12A) should not be recognised in applying IAS 12. This is because it is not clear what the economic benefit embodied in the deferred tax asset is, if recovering

[2] http://www.ifrs.org/Meetings/MeetingDocs/Interpretations%20Committee/2013/May/AP12-LSP-Recognition-deferred-tax-assets.pdf

[3] In this Staff Paper, monetary items are denominated in 'currency units' (CU).

the debt instrument by holding it until the unrealised loss reverses does not reduce future tax payments and instead only avoids higher tax losses.

19. Furthermore, the Interpretations Committee was not convinced that the arguments given by the FASB for proposing to introduce the separate assessment into US GAAP indicated that the IASB should introduce the separate assessment into IAS 12.

20. The FASB explained in paragraph BC242 of its 2013 ED:

> The guidance in this proposed Update would require an entity to evaluate the need for a valuation allowance for a deferred tax asset related to unrealized losses on debt instruments recognized in other comprehensive income separately from other deferred tax assets, which may result in providing no valuation allowance. The Board decided that a valuation allowance may not be necessary because a deferred tax asset related to such unrealized losses results from the interaction of Topic 740 and Topic 320 and, therefore, is unique. The proposed accounting acknowledges that this issue is a special case stemming from the interaction of accounting requirements and that the unrealized losses on debt instruments recognized in other comprehensive income are unrelated to other items that give rise to deferred tax assets. Therefore, the need for a valuation allowance should be evaluated separately.

Interaction of Topic 740 and Topic 320

21. The interaction of Topic 740 and Topic 320 of the *FASB Accounting Standards Codification*® results from the fact that qualifying changes in the fair value of available-for-sale financial instruments are not recognised in income from continuing operations but in OCI. This raises the question of whether deferred tax assets, and deferred tax liabilities, and changes in deferred tax assets, and deferred tax liabilities, and changes in the valuation allowance on deferred tax assets, should also be recognised in OCI or in income from continuing operations.

22. A similar issue arises for deferred tax assets and deferred tax liabilities related to available-for-sale financial instruments within the scope of IAS 39 *Financial*

Instruments: Recognition and Measurement and it would arise for FVOCI financial assets within the scope of a future IFRS 9 *Financial Instruments* that had been amended following the Exposure Draft *Classification and Measurement: Limited Amendments to IFRS 9* (ED/2012/4) (the IFRS 9 ED).[4]

23. However, the 'interaction issue' only relates, as far as IFRS is concerned, to where to present changes in deferred tax assets and deferred tax liabilities: in profit or loss or OCI. It does not address the question of whether a deductible temporary difference can be utilised and therefore whether the related deferred tax asset can be recognised.

24. Utilising a deductible temporary difference requires sufficient future taxable profits against which the tax deduction resulting from the reversal of the deductible temporary difference can be utilised (see paragraphs 24 and 27 of IAS 12). This assessment has to be done by applying tax law and the Interpretations Committee thinks that it is irrelevant for this assessment whether the tax effects represented by the deferred tax assets are recognised in profit or loss or in OCI in the IFRS financial statements.

25. Consequently, the Interpretations Committee does not think that, as far as IFRS is concerned, the recognition of unrealised gains and losses on financial assets in OCI requires or justifies the separate assessment of the utilisation of deductible temporary differences related to unrealised losses on FVOCI debt instruments.

Unrelated to other items

26. The FASB explains that it proposes the *separate assessment* because unrealised losses on debt instruments recognised in OCI are unrelated to other items that give rise to deferred tax assets.

27. We understand that this is because the recovery of the unrealised loss results not from recovering the carrying amount of the debt instrument, but instead from the entity's intention and ability to hold the investment in the debt instrument until recovery, which may be maturity.

[4] http://www.ifrs.org/Current-Projects/IASB-Projects/Financial-Instruments-A-Replacement-of-IAS-39-Financial-Instruments-Recognitio/Limited-modifications-to-IFRS-9/Documents/ED-Classification-and-Measurement-November-2012-bookmarks.pdf

28. While the Interpretations Committee agrees with the reason for the recovery of the unrealised loss, it does not think that, as far as IFRS is concerned, this fact requires or justifies the separate assessment of deferred tax assets related to such an unrealised loss.

29. Like all other deductible temporary differences, deductible temporary differences related to unrealised losses on FVOCI debt instruments represent tax deductions beyond the carrying amount of an asset or a liability (see paragraphs 5 and 27 of IAS 12).

30. Like all other deferred tax assets, deferred tax assets related to unrealised losses on FVOCI debt instruments represent probable future reductions of tax payments (see paragraph 27 of IAS 12). Future tax deductions can only be achieved by either offsetting the tax deductions resulting from recovering the carrying amount of an asset or settling a liability against probable future taxable profits.

31. Consequently, the Interpretations Committee does not think that the recognition of unrealised gains and losses on financial assets in OCI requires or justifies the separate assessment of the utilisation of deductible temporary differences related to unrealised losses on FVOCI debt instruments in applying IAS 12.

Realisation of the tax benefit

32. Furthermore, paragraph BC240 of the FASB's 2013 ED states the argument of many commentators that the recovery of the unrealised losses in OCI by holding an investment in a debt instrument until recovery of its amortised cost basis, and the corresponding reversals of the deferred tax asset, can be viewed as the realisation of its tax benefit.

33. The Interpretations Committee thought that this view is inconsistent with the approach of IAS 12 to deferred tax. This is because the tax benefit embodied in a deferred tax asset is the probable reduction of future tax payments through either recovering the carrying amount of the underlying asset or settling the carrying amount of the underlying liability (see paragraph 27 of IAS 12).

34. The recovery of an unrealised loss in OCI and the corresponding reversal of the deferred tax asset by holding an investment in a debt instrument until recovery of its amortised cost basis does not represent an inflow of economic benefits. Instead, it reflects measurement adjustments for financial assets measured at fair value, for example, resulting from the accretion of a discount in the fair value of the asset, that are recognised in the statement of financial position and in profit or loss and OCI.

35. The Interpretations Committee thought that such measurement adjustments are not realisations of the tax benefit of a deferred tax asset that consists of avoiding an outflow of economic benefits in the form of tax payments.

Non-economic equity volatility for life insurance companies

36. Furthermore, the Interpretations Committee was not convinced by arguments from commentators on the IASB's Exposure Draft *Annual Improvements to IFRSs 2010–2012 Cycle* (ED/2012/1)[5] (the 'Annual Improvements ED'), which was published in May 2012, that supported the consistent outcome approach.

37. In particular, the American Council of Life Insurers (ACLI) argued in its comment letter on the Annual Improvements ED that because of the size of life insurers' available-for-sale debt security portfolios, unrealised gains and losses can be extremely significant and cause unwarranted equity volatility.[6]

38. Consider, for example, an available-for-sale debt instrument that decreases in value, but then recovers as the debt instrument matures. The volatility would not be smoothed by the recognition of a deferred tax asset. ACLI thinks that this is not a clear reflection of a life insurer's financial position when the entity has demonstrated its ability and intention to hold the available-for-sale debt instrument until recovery or maturity and can therefore avoid realising the loss.

39. The Interpretations Committee agreed with ACLI that not recognising the deferred tax assets related to unrealised losses on debt instruments measured at fair value increases

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

[6] http://www.ifrs.org/Current-Projects/IASB-Projects/Annual-Improvements/ED-May-2012/Comment-Letters/Pages/Comment-Letters.aspx

the equity volatility. It thinks that this volatility might even be increased by fair value changes because of market volatility that turns an unrealised loss into an unrealised gain.

40. The Interpretations Committee also understands that this volatility might have regulatory implications for financial institutions.

41. However, it does not think that this justifies the recognition of a deferred tax asset if it would not embody an economic benefit. Equity volatility does not, in its view, imply an economic benefit of deferred tax assets.

Deferral account

42. On the basis of these conclusions, the Interpretations Committee understands that as far as IFRS is concerned, the deferred tax asset of CU66,953 for unrealised losses on debt instruments measured at fair value in the example in Staff Paper 12A is not an ‘asset’ but a ‘deferral account’ (see paragraph 42 in Staff Paper 12A).

43. It thinks that the principles in IAS 12 should not be modified for recognising a deferral account, even if it would smooth equity volatility.