STAFF PAPER

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IASB Meeting

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Project	**Narrow-scope amendment: IAS 12 *Income Taxes*—Recognition of Deferred Tax Assets for Unrealised Losses**
Paper topic	Summary of the Interpretations Committee's recommendations

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Introduction

1. In August 2014 the IASB published the Exposure Draft ('the ED') *Recognition of Deferred Tax Assets for Unrealised Losses* (ED/2014/3), which contained a proposal to amend IAS 12 *Income Taxes* to clarify the guidance on recognition of a deferred tax asset that is related to a debt instrument measured at fair value.

2. At the March 2015 meeting, the Interpretations Committee was presented with a summary and an analysis of the 68 comment letters received on the ED. This summary is included in Agenda Paper 3 of March 2015 for the Interpretations Committee meeting.

3. The members of the Interpretations Committee discussed the comments received and the staff recommendations to finalise the amendment to IAS 12.

4. All the members of the Interpretations Committee recommended that the IASB should proceed to finalise the proposed amendment, but some members recommended that the staff should shorten or clarify the proposed amendment further. Some other members raised some specific concerns about the proposed amendments that they thought should be addressed when finalising the amendments. We will address the

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recommendation and concerns in the body of this paper when referring to the Interpretations Committee's recommendations on the proposed amendments.

Purpose of this paper

5. The purpose of this paper is to:
   (a) present to the IASB the Interpretations Committee's recommendations on the proposed amendments to IAS 12 that it discussed at its meeting in March 2015; and
   (b) obtain an IASB decision on the finalisation of these proposed amendments.

Structure of the paper

6. This paper:
   (a) provides a description of the issue that led to the proposed amendments to IAS 12;
   (b) summarises the comments received from respondents and the changes that the Interpretations Committee decided to propose to the IASB for finalisation of the proposed amendments in response to the comments received;
   (c) addresses the Interpretations Committee's recommendations on the proposed amendments; and
   (d) asks the IASB for its agreement to revise the proposed amendments in response to the concerns raised by the Interpretations Committee, and its agreement with the Interpretations Committee's recommendation that the IASB finalise the proposed amendment.
7. Staff Paper 12B(i) is provided to illustrate the wording changes described in this paper and to provide context for the discussion. However, we are not asking the IASB to approve specific wording or to provide specific comments on the wording unless those comments are about the principles. We will collect editorial comments from IASB members later and not in the meeting.

Description of the issue

8. The Interpretations Committee received a request to clarify the accounting for a deferred tax asset for unrealised losses on debt instruments measured at fair value.

9. The issue had initially been considered as part of the Exposure Draft *Annual Improvements to IFRSs 2010-2012 Cycle(ED/2012/1)* which proposed to clarify that:

   (a) 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; and

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

10. However, on the basis of the comment letters received, the IASB decided that a narrow-scope amendment would be required to address two additional issues:

    (a) whether an unrealised loss on a debt instrument gives rise to a deductible temporary difference when the holder expects to recover the carrying amount of the asset by holding it to maturity and collecting all the contractual cash flows; and

    (b) whether an entity can assume recovery of an asset for more than its carrying amount when estimating probable future taxable profits against which deductible temporary differences can be utilised.

11. The IASB observed that there is diversity in practice because of uncertainty about the application of some of the principles in IAS 12.

12. At its meeting in May 2014, the IASB agreed with the Interpretations Committee's recommendation that the following aspects should be clarified in IAS 12, mainly by adding an illustrative example:

    (a) an unrealised loss on a debt instrument measured at fair value gives rise to a deductible temporary difference even if:

        (i) the debt instrument holder expects to recover the instrument's carrying amount by holding it to maturity and collecting all of the contractual cash flows; and

(ii) the loss is not tax-deductible until realised.

(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. If tax law, however, restricts the utilisation of deductible temporary differences so that they are deductible only against the taxable profits of a specific type, the entity still assesses utilisation of such deductible temporary differences in combination with other deductible temporary differences, but only of the appropriate type.

(c) an entity's estimate of future taxable profit includes amounts from recovering assets for more than their carrying amounts.

(d) an entity's estimate of future taxable profit excludes tax deductions resulting from the reversal of deductible temporary differences.

13. However, the IASB decided that the items in paragraphs 12 (a)-(c) of this paper should also be addressed by amending the mandatory guidance in IAS 12, in addition to providing an illustrative example.

14. The IASB also proposed to require limited retrospective application of the proposed amendments for entities already applying IFRS, to avoid undue cost and effort. This proposed limited retrospective application does not require allocation of the changes in equity of its opening statement of financial position between retained earnings and other components of equity.

Summary of comment letters and proposed changes to the ED

15. The IASB received 68 comment letters on the ED. From these comment letters:

(a) most respondents agreed with the proposal to amend IAS 12, because they thought that this proposal is consistent with the principle in IAS 12 and it reduces the risk of diversity in practice;

(b) however, some respondents expressed views that it should be further clarified or simplified. Some other respondents commented that the amendments are not necessary; and

(c) several respondents did not support the proposed limited retrospective application for entities already applying IFRS, and some respondents requested further clarification of the transition proposals.

16. For further details on the comment letter analysis discussed by the Interpretations Committee, refer to Agenda Paper 3 presented at the March 2015 meeting.

17. The Interpretations Committee decided to propose that the IASB should proceed with the proposed amendments, subject to some amendments to the proposed wording as follows:

(a) revise the example illustrating paragraph 26(d) to clarify that the debt instrument is measured at fair value and remove information that is superfluous to the objective of the example, to shorten it.

(b) delete the last two sentences of paragraph 29A and the examples in the last sentence of paragraph BC15 to resolve the concern that the proposed examples could be misinterpreted as meaning that an entity should assess future taxable profit on an individual asset basis.

(c) add a sentence in paragraph BC18 to clarify that 'taxable profit excluding tax deductions' used for assessing the utilisation of deductible temporary differences is different from 'taxable profit on which income taxes are payable', to respond to the concern that the use of a single term 'taxable profit' for two different concepts might be a source of confusion.

(d) add a sentence in paragraph BC24 to clarify the transition requirements to address the concern that the proposed transition relief is unclear and confusing.

(e) shorten Illustrative Example 7 and amend it to be consistent with paragraph 63.

The recommendations of the Interpretations Committee on the ED

18. Some members of the Interpretations Committee expressed views that:

    (a) **Existence of a deductible temporary difference**—the example illustrating paragraph 26(d) should be further shortened and the identification of the tax base should be further clarified in the Basis for Conclusions (hereafter, Issue 1);

    (b) **Recovering an asset for more than its carrying amount**—a discussion should be included in the Basis for Conclusions of the concern about the ability of an entity to recover an asset for more than its carrying amount when it is measured at fair value and when recovery is not based on contractual cash flows (hereafter, Issue 2); and

    (c) **Transition relief**—limited retrospective application should be further clarified and consideration given to whether it would cause any issue regarding the recycling of amounts from other comprehensive income (OCI) ('reclassification adjustment') and the process of remeasuring a deferred tax asset in subsequent periods ('backwards tracing') (hereafter, Issue 3).

19. Those members of the Interpretations Committee asked the staff to address those views in the proposed amendments to IAS 12.

20. We will address these matters in paragraphs below.

Issue 1 : Existence of a deductible temporary difference

The example illustrating paragraph 26(d) should be further shortened

21. Some members of the Interpretations Committee recommended that the example illustrating paragraph 26(d) should be further shortened, because they think that it is disproportionate to other examples in the mandatory guidance of IAS 12.

Staff analysis and recommendation

22. The objective of the example illustrating paragraph 26(d) is to clarify the identification of a deductible temporary difference in the case of an unrealised loss on a fixed-rate debt instrument measured at fair value, irrespective of the expected manner of recovery.

23. Some people argue that in such a case, a difference between the carrying amount and its higher tax base does not give rise to a deductible temporary difference because the payment of the principal at maturity is a non-taxable event.

24. The existence of a deductible temporary difference follows from the identification of the tax deduction. Consequently, this example illustrates that there is a tax deduction in the amount of the tax base either on sale or on maturity.

25. We think that the detailed explanations in the example will enhance understanding. However, we also understand that the example illustrating paragraph 26(d) is quite a bit longer than the other examples in the mandatory guidance of IAS 12.

26. We think that the example could be shortened without losing its context. Our proposed edits to shorten the example illustrating paragraph 26(d) are included in Agenda Paper 12B(i).

The identification of the tax base should be further clarified in the Basis for Conclusions

27. Some Interpretations Committee members think that the existence of a deductible temporary difference should be further clarified, because the explanation in the Basis for Conclusions is not sufficiently clear.

28. They suggested that the identification of the tax base in the example should be further explained to strengthen the reasoning against the contrary view that there are no tax consequences if the principal is paid on maturity and that the deferred tax asset should therefore be measured at nil.

Staff analysis and recommendation

29. We think that the explanation of the basic premise on which IAS 12 is based should be added in response to the Interpretations Committee members' suggestion for further clarification in relation to the tax base.

30. IAS 12 is based on a 'temporary difference' approach, which is defined as 'differences between the carrying amount of an asset or liability in the statement of financial position and its tax base'. The tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset.

31. Under the temporary difference approach, the tax effects of all temporary differences are recognised in the financial statements, except for some exceptional cases listed in IAS 12, if they meet the recognition criteria in the case of a deductible temporary difference. There is no special treatment for a deductible temporary difference relating to an available-for-sale (AFS) debt instrument; hence the proposed amendments.

32. According to the objective of IAS 12, it is inherent in the recognition of an asset or liability that the reporting entity expects to recover or settle the carrying amount of that asset or liability. In determining deferred tax, IAS 12 focuses on the future tax consequences of recovering an asset only to the extent of the asset's carrying amount at the end of the reporting period.

33. However, the contrary view against the existence of a deductible temporary difference is based on an assessment of the economic benefits that are expected on maturity, not at the end of the reporting period. That view asserts that the payment of the principal at maturity is a non-taxable event, and therefore the difference between the carrying amount of an asset and the higher tax base does not give rise to a deductible temporary difference.

34. The proponents of that view argue that their view is based on the principle in paragraph 51 of IAS 12 that the measurement of deferred tax should reflect the tax consequences that would follow from the expected manner of recovery.

35. We agree that IAS 12 requires the measurement of deferred tax to reflect the expected manner of recovery. However, we observe that this still requires the calculation of the temporary difference as the difference between the carrying amount of the asset and the tax base. That carrying amount of the asset used to calculate the temporary difference should be that in the statement of financial position, not the carrying amount at maturity. Consequently, we disagree that the expected manner of recovery would result in no deductible temporary difference.

36. Our proposed edits to further clarify the existence of a deductible temporary difference in paragraph BC6 are as follows;

(BC4) Because the payment of the principal does not increase or decrease the taxable profit that is reported for tax purposes, some believe that the payment of the principal is a non-taxable event. Sometimes, tax law does not explicitly address whether the payment of the principal has tax consequences. Consequently, proponents of this view think that a difference between the carrying amount of the debt instrument in the statement of financial position and its higher 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 for tax purposes.

…

(BC6) The IASB considered the guidance in IAS 12 on the identification of temporary differences and rejected the reasoning presented in paragraph BC4. 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. This is because IAS 12 is based on the premise that the entity will recover the carrying amount of an asset, and hence economic benefits will flow to the entity in future periods to the extent of the asset's carrying amount at the end of the reporting period. In contrast, the view presented in paragraph BC4 is based on the assessment of the economic benefits that are expected on maturity. The IASB noted that the existence of a deductible temporary difference depends solely on a comparison of the carrying amount of an asset and its tax base at the end of the reporting period, and is not affected by possible future changes in the carrying amount.

Issue 2 : Recovering an asset more than its carrying amount

36. The purpose of adding paragraph 29A in the proposed amendments is to clarify that the carrying amount of an asset does not restrict the estimation of probable future taxable profit. This proposed amendment was to address a common misunderstanding in practice that the limitation of the use of the carrying amount of an asset to calculate the amount of a temporary difference also applied to the estimation of probable future taxable profit.

37. However, some members of the Interpretations Committee members expressed concern about the ability of an entity to recover an asset for more than its carrying amount when it is measured at fair value and when recovery is not based on contractual cash flows.

38. In addition, one member was concerned that any guidance on this point might give the false impression that future taxable profit is determined on an individual asset basis. He therefore thought that any guidance on this point should be confined to the Basis for Conclusions.

39. Another member thought that paragraph 29A is not sufficient to provide guidance for other assets except for an AFS debt instrument with contractual cash flows.

40. They asked the staff to address this issue in the amendment.

Staff analysis and recommendation

41. In the comment letters, there were no respondents who disagreed with the principle of this proposed amendment. The main reason for their support is that the proposed amendment will reduce diversity in practice by clarifying that determining temporary differences and estimating probable taxable profits are two separate steps.

42. However, there were different views on how to address this issue in the ED. Some respondents to the ED expressed the view that the proposed amendment should be clarified to avoid unintended consequences. They were concerned that the guidance would be applied more broadly, and in their view, inappropriately to other assets measured at fair value, and not merely to AFS debt instruments.

43. On the contrary, some other respondents expressed concerns that the examples about recovering an asset for more than its carrying amount in the proposed amendment could create unnecessary confusion and result in departing from the principle in the Standard.

44. Some other respondents noted that the example of an impaired asset in paragraph 29A is not aligned well with IFRS 9 because impairment loss under IFRS 9 is based on expected loss, not incurred loss as in IAS 39.

45. Even though this proposed amendment is based on the fact pattern of an AFS debt instrument, the principle that the estimate of probable future taxable profit includes an expected recovery of assets for more than their carrying amount is not limited to this specific fact pattern.

46. However, we also understand the concern that the general principle in paragraph 29A without any qualifying wording could create unintended consequences. There are many cases in which it may not be probable that an asset will be recovered for more than its carrying amount, especially if the asset is measured at fair value. It could be the case, for example, that an entity might inappropriately assume that an equity instrument will be recovered more than its carrying amount, based on the expectation that its market price will increase in the future.

47. In response to this concern, we think that entities will need to have a reasonable basis on which to base their estimate of probable future taxable profit, especially when an asset is measured at fair value.

48. For example, in the case of the fixed-rate debt instrument that led to this amendment, the expected collection of contractual cash flows might be a strong basis for concluding that it is probable that the asset will be recovered for more than its carrying amount.

49. We note the concern that any guidance regarding this issue could be misinterpreted as requiring the estimate of future taxable profit on an individual asset basis. However, we think that adding the explanation about a strong basis with an example of the specific fact pattern could enhance understanding and reduce the risk of arbitrary estimates of future taxable profit.

50. Our proposed edit to further clarify this issue in paragraph 29A is as follows.

~~Estimating taxable profit in future periods (see paragraph 29(a)) requires assessing whether and to what extent it is probable that the assets of the entity will be recovered for more than their carrying amount. An entity considers all relevant facts and circumstances when making this assessment. Recovery of an asset for more than its carrying amount is unlikely to be probable if, for example, it was recently impaired. Conversely, recovery of an asset for more than its carrying amount is likely probable, if, for example, it is measured at cost and used in a profitable operation.~~ The estimate of probable future taxable profit may include an expected recovery of some of the entity's assets for more than their carrying amount. When an asset is measured at fair value, the entity should carefully consider whether there is a sufficiently strong basis for concluding that it will be recovered for more than the carrying amount. This might be the case, for example, when the basis for the estimate is the expected collection of contractual cash flows, as might be appropriate for a fixed-rate debt instrument.

51. Our proposed edits to add the discussion about the concern in paragraph BC15 are as follows.

However, there are cases in which it may not be probable that an asset will be recovered for more than its carrying amount, especially if the asset is measured at fair value.~~on the basis of expected cash flows~~. ~~Examples of this are many assets measured at fair value or asset that have been impaired recently~~.

Some respondents to the Exposure Draft expressed concern that the guidance might be applied more broadly, and in their view, inappropriately to other assets, and not merely to debt instruments measured at fair value. Some other respondents were concerned that any guidance would give the false impression that future taxable profit should be estimated on an individual asset basis. The IASB noted that the principle that the estimate of probable future taxable profit includes an expected recovery of assets for more than their carrying amount is not limited to specific assets. However, the IASB also considered the concern that an entity should take care not to inappropriately assume that an asset measured at fair value will be recovered for more than its carrying amount. In response to that concern, the IASB thought that entities will need to have a reasonable basis on which to base their estimate of probable future taxable profit, especially when that estimate includes the estimated recovery of an asset for more than carrying amount when that asset is measured at

fair value. For example, for a fixed-rate debt instrument, the expected collection of contractual cash flows might be a strong basis on which to conclude that it is probable that the asset will be recovered for more than its carrying amount. The IASB thought that such an example could enhance understanding and reduce the risk of arbitrary estimates of future taxable profit.

Issue 3 : Transition relief

Limited retrospective application should be further clarified

49. Some members of the Interpretations Committee expressed a similar view to that of some respondents to the ED, namely that limited retrospective application is confusing. In particular, it is not clear whether an entity would be required to restate opening retained earnings or other components of equity. They suggested that the transition arrangement should be described more clearly.

Staff analysis and recommendation

50. We acknowledge that the description of limited retrospective application could be confusing. We propose the following clarification for paragraph 98G.

.. An entity shall apply those amendments retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. However, an entity may choose ~~is not required~~ to recognise the change in equity in its opening statement of financial position in retained earnings (or in another component of equity, as appropriate) ~~restate the opening retained earnings or other components of equity of the earliest comparative period presented~~. If an entity chooses to apply this relief ~~does not make such restatements~~, it shall disclose that fact.

51. We propose that we do not use the term 'limited retrospective application' but instead describe the transition requirements. Our proposed edit in the paragraph BC24 is as follows.

The IASB requires ~~a limited retrospective application for entities already applying IFRS~~ the adjustment of comparative information for any earlier periods presented. However, this amendment allows the change in opening equity of the earliest comparative period presented that arises upon first application of the amendment to be recognised in opening retained earnings (or in another component of equity, as

appropriate), without the need to allocate the change between opening retained earnings and other components of equity. ~~Restatements of the opening retained earnings or other components of equity of the earliest comparative period presented should be allowed but not be required~~. This is to avoid undue cost and effort.

Consideration of whether the transition relief would cause any issue regarding reclassification adjustment and backwards tracing

52. One member of the Interpretations Committee asked the staff to consider whether limited retrospective application would create an issue with regard to reclassification adjustment or backwards tracing in subsequent periods.

Staff analysis and recommendation

53. With regard to the concern raised about reclassification adjustment, we think that the subsequent accounting treatment should be consistent with how the transaction was originally recognised.

54. These proposed amendments relate primarily to recognition of deferred tax assets on unrealised losses of AFS debt instruments. In accordance with paragraph 55(b) in IAS 39, the cumulative gain or loss on AFS debt instruments previously recognised in OCI shall be reclassified from equity to profit or loss when the AFS debt instruments are derecognised.

55. Because deferred tax arising upon the application of these amendments is recognised in OCI when the gains or losses on transaction are initially recognised in OCI, the related amount recognised in OCI shall be equally reclassified to profit or loss upon derecognition of the AFS debt instruments. This is consistent with the accounting when the gains or losses are initially recognised in OCI.

56. However, if the deferred tax effect is recognised in retained earnings in accordance with the transition relief, there will be no need for a reclassification adjustment. This is because there is no OCI related to deferred tax to be recycled to profit or loss on derecognition.

57. With regard to the concern raised about backwards tracing, we think that the current IAS 12 prescribes the accounting treatment.

58. The carrying amount of the deferred tax asset may change in a subsequent period; for example, because of a change in tax rates. Paragraph 60 of IAS 12 notes that a change in the carrying amount of deferred tax is recognised in profit or loss, except to the extent that it relates to items previously recognised outside profit or loss.

59. Paragraph 61A also states that current tax and deferred tax shall be recognised outside profit or loss if the tax relates to items that are recognised, in the same or a different period, outside profit or loss.

60. We think that any subsequent changes in deferred taxes should be consistent with accounting for the deferred tax previously recognised in accordance with the principles of IAS 12. If deferred tax is recognised outside profit or loss (either in OCI or directly in equity), the resulting adjustment from a change of tax rates shall be reflected in the same items originally recognised.

61. Consequently, the transition relief does not make backwards tracing problematic because the current IAS 12 already gives guidance that backwards tracing should be consistent with the item previously recognised.

62. However, the reclassification adjustment or backwards tracing in subsequent periods could result in different profit or loss, depending on whether the transition relief was applied. We think that this is a mechanical consequence of applying the transition relief. We do not think that this will cause confusion in practice, nor do we think that this should cause us to reconsider making transition relief available.

63. In most cases, we think that it would be straightforward to apply retrospective application if the carrying amounts, their tax bases, the estimate of probable future taxable profit and the basis for allocating deferred tax between profit or loss, OCI and equity are known.

64. However, we think that in some cases, retrospective application could be onerous. This is because paragraph 63 of IAS 12 allows a ‘reasonable pro rata allocation’ or ‘other method that achieves a more appropriate allocation in the circumstances’ when it is difficult to determine the amount of current and deferred tax that relates to items that are recognised outside profit or loss.

65. For example, in such a circumstance, some entities that choose an 'other method' might need to reanalyse the cumulative amounts that are recognised OCI and equity in the opening statement of financial position, which may require going back many years.

66. Consequently, we still think that the cost of retrospective application for some entities could outweigh the benefit. We also continue to think that the transition relief proposed should be an option, not mandatory, because retrospective application is the most desirable way to represent the financial statements if this is not onerous.

Summary of proposed changes to respond to recommendations from the Interpretations Committee

67. The changes to the draft wording in the proposed amendments to IAS 12 regarding to the Interpretations Committee's recommendations are summarised as follows:

    (a) further shorten the example illustrating paragraph 26(d) and add the explanation about the identification of the tax base in paragraph BC6 to strengthen the reasoning against the contrary view;

    (b) revise paragraph 98G to make the transition requirements clearer; and

    (c) revise paragraph 29A by including guidance about a strong basis and the related example, and add the discussion in paragraph BC15, to respond to the concern about an entity recovering an asset measured at fair value for more than its carrying amount.

Questions for the IASB

Questions for the IASB
1. Does the IASB agree with the recommended revisions to the proposed amendment to IAS 12 in response to the Interpretations Committee's recommendations, as described in this agenda paper? 2. Does the IASB agree with the Interpretations Committee's recommendations about proceeding with the amendment to clarify the guidance on recognition of a deferred tax asset that is related to a debt instrument measured at fair value?