International Financial Reporting Standard

Recognition of Deferred Tax Assets for Unrealised Losses

January 2016

BASIS FOR CONCLUSIONS – AMENDMENTS

[IAS 12]

[Related to AASB 2016-1]

Amendments to the Basis for Conclusions on IAS 12 *Income Taxes*

Paragraphs BC1A and BC37–BC62 and their related headings are added. New text is underlined.

Introduction

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BC1A In August 2014 the Board published an Exposure Draft of proposed amendments to IAS 12 to clarify the requirements on recognition of deferred tax assets for unrealised losses on debt instruments measured at fair value. The Board subsequently modified and confirmed the proposals and in January 2016 issued *Recognition of Deferred Tax Assets for Unrealised Losses* (Amendments to IAS 12). The Board's considerations and reasons for its conclusions are discussed in paragraphs BC37–BC62.

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Recognition of Deferred Tax Assets for Unrealised Losses (2016 amendments)

BC37 The IFRS Interpretations Committee (the 'Interpretations Committee') was asked to provide guidance on how an entity determines, in accordance with IAS 12, whether to recognise a deferred tax asset when:

(a) the entity has a debt instrument that is classified as an available-for-sale financial asset in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*.[1] Changes in the market interest rate result in a decrease in the fair value of the debt instrument to below its cost (ie it has an 'unrealised loss');

(b) it is probable that the issuer of the debt instrument will make all the contractual payments;

(c) the tax base of the debt instrument is cost;

(d) tax law does not allow a loss to be deducted on a debt instrument until the loss is realised for tax purposes;

(e) the entity has the ability and intention to hold the debt instrument until the unrealised loss reverses (which may be at its maturity);

(f) tax law distinguishes between capital gains and losses and ordinary income and losses. While capital losses can only be offset against capital gains, ordinary losses can be offset against both capital gains and ordinary income; and

1 IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39. Under IFRS 9, the same question arises for debt instruments measured at fair value.

(g) the entity has insufficient taxable temporary differences and no other probable taxable profits against which the entity can utilise deductible temporary differences.

BC38 The Interpretations Committee reported to the Board that practice differed because of divergent views on the following questions:

(a) Do decreases in the carrying amount of a fixed-rate debt instrument for which the principal is paid on maturity always give rise to a deductible temporary difference if this debt instrument is measured at fair value and if its tax base remains at cost? In particular, do they give rise to a deductible temporary difference if the debt instrument's holder expects to recover the carrying amount of the asset by use, ie continuing to hold it, and if it is probable that the issuer will pay all the contractual cash flows? (see paragraphs BC39–BC45)

(b) Does an entity assume that it will recover an asset for more than its carrying amount when estimating probable future taxable profit against which deductible temporary differences are assessed for utilisation if such recovery is probable? This question is relevant when taxable profit from other sources is insufficient for the utilisation of the deductible temporary differences related to debt instruments measured at fair value. In this case, an entity may only be able to recognise deferred tax assets for its deductible temporary differences if it is probable that it will collect the entire cash flows from the debt instrument and therefore recover it for more than its carrying amount. (see paragraphs BC46–BC54)

(c) When an entity assesses whether it can utilise deductible temporary differences against probable future taxable profit, does that probable future taxable profit include the effects of reversing deductible temporary differences? (see paragraphs BC55–BC56)

(d) Does an entity assess whether a deferred tax asset is recognised for each deductible temporary difference separately or in combination with other deductible temporary differences? This question is relevant, for example, when tax law distinguishes capital gains and losses from other taxable gains and losses and capital losses can only be offset against capital gains. (see paragraphs BC57–BC59)

Existence of a deductible temporary difference

BC39 In the case of many debt instruments, the collection of the principal on maturity does not increase or decrease taxable profit that is reported for tax purposes. This is the case in the example illustrating paragraph 26(d) of IAS 12. Interest is paid at the contractual rate each year, and on maturity of the debt instrument the issuer pays the principal of CU1,000. In this example, if the investor continues to hold the debt instrument, the investor only pays taxes on the interest income. The collection of the principal does not trigger any tax payments.

BC40 Because the collection of the principal does not increase or decrease the taxable profit that is reported for tax purposes, some thought that the collection of the principal is a non-taxable event. Sometimes, tax law does not explicitly address whether the collection of the principal has tax consequences. Consequently, proponents of this view thought 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.

BC41 Those who held this view thought that the loss would not be realised for tax purposes if the entity has the ability and intention to hold the debt instrument over the period until the loss reverses, which might be until maturity, and it is probable that the entity will receive all the contractual cash flows. In this case, differences between the carrying amount of the debt instrument in the statement of financial position and its tax base reverse over the period to maturity, as a result of continuing to hold the debt instrument.

BC42 The Board considered the guidance in IAS 12 on the identification of temporary differences and rejected the reasoning presented in paragraphs BC40 and BC41. 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 the calculation of a temporary difference in 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 paragraphs BC40 and BC41 is based on the assessment of the economic benefits that are expected at maturity. The Board 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.

BC43 Consequently, the Board concluded that decreases below cost in the carrying amount of a fixed-rate debt instrument measured at fair value for which the tax base remains at cost give rise to a deductible temporary difference. This applies irrespective of whether the debt instrument's holder expects to recover the carrying amount of the debt instrument by sale or by use, ie continuing to hold it, or whether it is probable that the issuer will pay all the contractual cash flows. Normally, the collection of the entire principal does not increase or decrease taxable profit that is reported for tax purposes, because the tax base equals the inflow of taxable economic benefits when the principal is paid. Typically, the tax base of the debt instrument is deducted either on sale or on maturity.

BC44 The economic benefit embodied in the related deferred tax asset arises from the ability of the holder of the debt instrument to achieve future taxable gains in the amount of the deductible temporary difference without paying taxes on those gains. In contrast, an entity that acquires the debt instrument described in the example illustrating paragraph 26(d) of IAS 12 for its fair value at the end of Year 2 (in the example, CU918) and continues to hold it, has to pay taxes on a gain of CU82, whereas the entity in that example will not pay any taxes on the collection of the CU1,000 of principal. The Board concluded that it was appropriate for the different tax consequences for these two holders of the same instrument to be reflected in the deferred tax accounting for the debt instrument.

BC45 The Board has added an example after paragraph 26 of IAS 12 to illustrate the identification of a deductible temporary difference in the case of a fixed-rate debt instrument measured at fair value for which the principal is paid on maturity.

Recovering an asset for more than its carrying amount

BC46 The Board noted that paragraph 29 of IAS 12 identifies taxable profit in future periods 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.

BC47 The guidance in paragraph 29 of IAS 12 does not refer to the carrying amount of assets within the context of estimating probable future taxable profit. Some thought, however, that the carrying amount of an asset to which a temporary difference is related limits the estimate of future taxable profit. They argued that accounting for deferred taxes should be based on consistent assumptions, which implies that an entity cannot assume that, for one and the same asset, the entity will recover it:

(a) for its carrying amount when determining deductible temporary differences and taxable temporary differences; as well as

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

BC48 Consequently, proponents of this view thought that an entity cannot assume that it will collect the entire principal of CU1,000 in the example illustrating paragraph 26(d) of IAS 12 when determining probable future taxable profit. Instead, they thought that an entity must assume that it will collect only the carrying amount of the asset.

BC49 The Board noted however 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 of an asset is relevant only to determining temporary differences. The carrying amount of an asset does not limit the estimation of probable future taxable profit. In its estimate of probable future taxable profit, an entity includes the probable inflow of taxable economic benefits that results from recovering an asset. This probable inflow of taxable economic benefits may exceed the carrying amount of the asset.

BC50 Moreover, a limitation on the estimate of probable future taxable profit by the carrying amount of assets can lead to inappropriate results in other scenarios. For example, a significant part of the assets of a profitable manufacturing entity is property, plant and equipment and inventories. Property, plant and equipment may be measured using the cost model (paragraph 30 of IAS 16 *Property, Plant and Equipment)* and inventories are measured at the lower of cost and net realisable value (paragraph 9 of IAS 2 *Inventories*). If such an entity expects to generate future taxable profit, it may be inconsistent to assume that it will only recover these assets for their carrying amount. This is because a significant part of the manufacturing entity's probable future taxable profit results from using those assets to generate taxable profit in excess of their carrying amount.

BC51 If a limitation such as the one described in paragraph BC50 was made, then, for the purpose of consistency, the entity would need to assume that it will not recover any of its assets for more than their carrying amount. The Board decided that it would not be appropriate to limit the estimate of probable future taxable profit to the carrying amount of related assets only for assets to which temporary differences are related, because there is no basis for a different assessment that would depend on whether a deductible temporary difference is related to an asset or not.

BC52 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 Board noted that the principle that the estimate of probable future taxable profit includes an expected recovery of assets for more than their carrying amounts is not limited to any specific type or class of assets.

BC53 However, the Board also noted that there are cases in which it may not be probable that an asset will be recovered for more than its carrying amount. An entity should not inappropriately assume that an asset will be recovered for more than its carrying amount. The Board thought that this is particularly important when the asset is measured at fair value. In response to that concern, the Board noted that entities will need to have sufficient evidence on which to base their estimate of probable future taxable profit, including when that estimate involves the recovery of an asset for more than its carrying amount. For example, in the case of a fixed-rate debt instrument measured at fair value, the entity may judge that the contractual nature of future cash flows, as well as the assessment of the likelihood that those contractual cash flows will be received, adequately supports the conclusion that it is probable that it will recover the fixed-rate debt instrument for more than its carrying amount, if the expected cash flows exceed the debt instrument's carrying amount. The Board thought that such an example could enhance understanding and reduce the risk of arbitrary estimates of future taxable profit.

BC54 The Board has added paragraph 29A to IAS 12 to clarify to what extent an entity's estimate of future taxable profit (paragraph 29) includes amounts from recovering assets for more than their carrying amounts.

Probable future taxable profit against which deductible temporary differences are assessed for utilisation

BC55 The Interpretations Committee observed that there is uncertainty about how to determine probable future taxable profit against which deductible temporary differences are assessed for utilisation when this profit is being assessed to determine the recognition of all deferred tax assets. The uncertainty relates to whether the probable future taxable profit should include or exclude deductions that will arise when those deductible temporary differences reverse.

BC56 The Board noted that deductible temporary differences are utilised by deduction against taxable profit, excluding deductions arising from reversal of those deductible temporary differences. Consequently, taxable profit used for assessing the utilisation of deductible temporary differences is different from taxable profit on which income taxes are payable, as defined in paragraph 5 of IAS 12. If those deductions were not excluded, then they would be counted twice. The Board has amended paragraph 29(a) to clarify this.

Combined versus separate assessment

BC57 The Board considered the guidance in IAS 12 on the recognition of deferred tax assets. Paragraph 24 of IAS 12 requires deferred tax assets to be recognised only to the extent of probable future taxable profit against which the deductible temporary differences can be utilised. Paragraph 27 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 can be offset.

BC58 The Board noted that:

(a) tax law determines which deductions are offset against taxable income in determining taxable profits. The Board also noted that 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.

(b) no deferred tax asset is recognised if the reversal of the deductible temporary difference will not lead to tax deductions.

BC59 Consequently, if tax law offsets a deduction against taxable income on an entity basis, without segregating deductions from different sources, an entity carries out a combined assessment of all its deductible temporary differences relating to the same taxation authority and the same taxable entity. However, if tax law offsets specific types of losses only against a particular type, or types, of income (for example, if tax law limits the offset of capital losses to capital gains), an entity assesses a deductible temporary difference in combination with other deductible temporary differences of that type(s), but separately from other deductible temporary differences. Segregating deductible temporary differences in accordance with tax law and assessing them on such a basis is necessary to determine whether taxable profits are sufficient to utilise deductible temporary differences. The Board has added paragraph 27A to IAS 12 to clarify this.

Transition

BC60 The Board decided to require 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 the 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. This is to avoid undue cost and effort.

BC61 The Board noted that, with the exception of the amounts that would have to be adjusted within equity, the accounting required by these proposed amendments is based on amounts and estimates at the end of the reporting periods. The changes to the accounting are mechanical in nature and so the Board expects that the cost of adjusting comparatives should not exceed the benefits of greater comparability.

BC62 The Board has not added additional transition relief for first-time adopters. This is consistent with the fact that IFRS 1 *First-time Adoption of International Financial Reporting Standards* does not include an exception to, or exemption from, the retrospective application of the requirements in IAS 12.