IFRS

STAFF PAPER

March 2018

IFRS Interpretations Committee Meeting

Project	Deferred tax - tax base of assets and liabilities		
Paper topic	Initial consideration		
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Introduction

1. The IFRS Interpretations Committee (Committee) received a question about the recognition of deferred taxes in particular circumstances—namely, when a lessee recognises an asset and liability at commencement of a lease (applying either IFRS 16 *Leases* or IAS 17 *Leases*).

2. A similar question has also arisen on initial recognition of decommissioning assets and liabilities applying IAS 16 *Property, Plant and Equipment* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

3. The objective of this paper is to:

   (a) provide the Committee with a summary of the matter;

   (b) present our research and analysis; and

   (c) ask the Committee whether it agrees with our recommendation not to add this matter to its standard-setting agenda.

Structure of the paper

4. This paper includes:

   (a) background information;

   (b) summary of outreach;

   (c) staff analysis; and

   (d) staff recommendation.

5. There are 2 appendices to the paper:

   (a) Appendix A—proposed wording of the tentative agenda decision; and

   (b) Appendix B—submission.

Background information

6. The submitter asks about the recognition of deferred tax in relation to leases and decommissioning liabilities.

7. Applying IFRS 16, at lease commencement a lessee recognises a right-of-use asset and a lease liability for all leases (except short-term leases and leases of low value assets that it accounts for applying paragraph 6 of IFRS 16). A lessee measures:

   (a) the lease liability at the present value of the lease payments that are not paid at that date; and

   (b) the right-of-use asset at the amount of the liability, adjusted for advance lease payments, initial direct costs and decommissioning costs.

8. Similarly, applying IAS 17, a lessee recognises finance leases as assets and liabilities at lease commencement. The submission describes a fact pattern in which the lease payments are deductible for tax purposes on a cash basis. Throughout this paper, we refer to the assets and liabilities a lessee recognises applying IFRS 16 or IAS 17 as lease assets and lease liabilities.

9. Applying IAS 37 and IAS 16, an entity recognises a decommissioning liability and includes in the cost of an item of property, plant and equipment the costs of

decommissioning the asset.[1] The amount recognised as a liability (and included in the cost of the asset) is the best estimate of the expenditure required to settle the decommissioning obligation. Similar to the leases example, the submission describes a fact pattern in which the decommissioning costs are deductible for tax purposes on a cash basis.

10. This paper analyses the applicable requirements in IAS 12 using leases as an example. The analysis would, however, apply equally to decommissioning assets and liabilities.

11. The submitter assumes that the recognition of a lease asset and lease liability at lease commencement gives rise to a taxable temporary difference in relation to the asset and a deductible temporary difference in relation to the liability. The submitter then asks whether paragraphs 15 and 24 of IAS 12, ie the initial recognition exemption, applies. The submitter has identified three approaches as follows:

    (a) *Approach 1 – the initial recognition exemption applies*

    An entity applies the initial recognition exemption separately to the lease asset and lease liability.

    (b) *Approach 2 – the initial recognition exemption does not apply; lease asset and lease liability are 'integrally linked'*

    An entity assesses the lease asset and lease liability together on a net basis. Thus, assuming an entity has not made lease payments before lease commencement, temporary differences do not arise on initial recognition.

    (c) *Approach 3 – the initial recognition exemption does not apply to the gross temporary differences*

    The initial recognition exemption is assumed to apply only when an entity recognises an asset *or* liability. Thus, the initial recognition exemption does not apply on initial recognition of the lease asset and lease liability because an entity recognises an asset *and* liability at the same time.

12. Appendix B to this paper reproduces the submission, which explains each of these approaches in more detail.

[1] This is also the case for decommissioning costs associated with a right-of-use asset applying IFRS 16.

Summary of outreach

13. In order to gather information about the matter described in the submission, we sent requests to members of the International Forum of Accounting Standard-Setters, securities regulators, and the large accounting firms.

14. The request asked those participating to provide information, based on their experience, on the tax treatment of lease payments as well as the predominant and any other accounting treatments observed for leases and decommissioning assets and liabilities.

15. We received 17 responses—six from the large accounting firms, nine from national standard-setters and two from organisations representing groups of regulators. The views received represent informal opinions, rather than formal views of those responding.

Findings from outreach

16. Most respondents, including those from Canada, Norway, Australia, France and Malaysia, say lease payments are deductible for tax purposes on a cash basis. In some jurisdictions, for example in Japan, the tax treatment of both finance and operating leases broadly aligns with the accounting treatment in IAS 17. This means depreciation of a finance lease asset is deductible for tax purposes when recognised in profit or loss, and operating lease payments are deductible for tax purposes on a cash basis. In some jurisdictions, for example in the UK, the tax rules governing lease payments are complex. Operating lease payments are deductible for tax purposes on a cash basis, but payments under long-term leases might receive a form of depreciation deduction. There are specific rules for plant and machinery, property, and sale and leaseback transactions.

17. Most respondents say they have observed different approaches to the recognition of deferred tax with respect to leases. In most jurisdictions entities predominantly apply Approach 1 or Approach 2, however in some jurisdictions, for example in Norway, Approach 3 prevails.

18. Most respondents also say they have observed different approaches to the recognition of deferred tax with respect to decommissioning liabilities. However, one respondent says entities do not necessarily apply the same approach to finance leases and decommissioning liabilities. For example, one respondent says in their jurisdiction Approach 2 prevails with respect to finance leases but Approach 1 prevails with respect to decommissioning liabilities.

19. One respondent says in the oil and gas industry there are significant decommissioning liabilities, and entities typically apply Approach 3. Because tax rates for oil and gas companies can be high, the amounts involved can be significant for that sector.

20. One respondent says in jurisdictions for which tax deductions broadly align with the accounting in IAS 17, it is not yet clear whether tax laws will change to reflect the requirements in IFRS 16.

Staff analysis

21. As mentioned in paragraph 11, the submission assumes temporary differences arise on initial recognition of lease assets and lease liabilities, and asks whether the initial recognition exemption applies. We do not agree with this assumption. In our view, as a first step an entity needs to determine *whether* there is a temporary difference on initial recognition of a lease asset and lease liability.

Tax base of lease asset and lease liability

22. Paragraph 5 of IAS 12 defines temporary differences as 'differences between the carrying amount of an asset or liability in the statement of financial position and its tax base'.

23. Paragraph 5 of IAS 12 also defines the tax base of an asset or liability as 'the amount attributed to that asset or liability for tax purposes'. Paragraphs 7 and 8 of IAS 12 state:

> 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. If those economic benefits will not be taxable, the tax base of the asset is equal to its carrying amount.
>
> The tax base of a liability is its carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods.

24. Accordingly, to determine whether temporary differences arise on initial recognition of the lease asset and lease liability, an entity needs to determine the tax base of that asset and liability. To do so, the entity considers the applicable tax law to determine the amount attributable to the lease asset and lease liability for tax purposes. In other words, the entity considers the applicable tax law to assess what the tax deductions relate to.

25. In our view, depending on the provisions of the applicable tax law, the entity might determine that the tax deductions are attributable to either:

    (a) the lease asset, because the deductions relate to the expenses arising from the lease, ie for IFRS reporting purposes depreciation and interest expense, discussed in paragraphs 31–42 of this paper; or

    (b) the repayment of the lease liability, discussed in paragraph 43 of this paper.

26. In the fact pattern in the submission, tax deductions are available for the payments made under the lease contract. This does not necessarily mean that the tax authority regards the deductions as relating to the repayment of a liability (as assumed in the submission). The tax authority is simply giving tax deductions for specified cash outflows. The entity recognises those cash outflows in profit or loss over the lease term as depreciation and interest expense. It is a matter of judgement, having considered the applicable tax law, as to whether the entity regards the tax deductions as relating to:

    (a) depreciation (and thus partly attributed to the lease asset) and interest expense, or

    (b) the repayment of the principal amount of the lease liability (and thus partly attributed to the lease liability) and interest expense.

27. The accounting for leases in IFRS 16 (finance leases in IAS 17) is similar to the accounting for the financed purchase of an asset (for example, when the entity obtains a loan to purchase an item of property, plant and equipment). In many jurisdictions, repayments of the principal amount of borrowings are not deductible for tax purposes. An entity more frequently receives tax deductions for the use of an asset (ie depreciation) and for interest payments on a loan. In these circumstances, we would expect the entity to attribute the tax deductions it claims for lease payments to the lease asset (for deductions relating to depreciation) and to the future interest accrual (for deductions relating to the future interest expense).

28. In contrast, in jurisdictions for which repayments of the principal amount of borrowings are deductible for tax purposes, we would expect the entity to attribute the tax deductions to the repayment of the lease liability (for deductions relating to the repayment of the principal) and to the future interest accrual (for deductions relating to the future interest expense).

29. In our view, determining the attribution of the tax deductions to the lease asset or lease liability as described in paragraph 25 of this paper is not an accounting policy choice. An entity applies judgement having considered and analysed the applicable tax laws. We would expect entities in the same tax jurisdiction to apply the same judgement for similar transactions.

30. An entity would disclose the judgement made applying paragraph 122 of IAS 1 *Presentation of Financial Statements* if that judgement is part of the entity's judgements made in applying its accounting policies that have the most significant effect on the amounts recognised in the financial statements.

Tax deductions are attributable to the lease asset

31. When an entity attributes the tax deductions to the lease asset and future interest accrual, at lease commencement the tax base of the asset equals its carrying amount[2] applying paragraph 7 of IAS 12 (reproduced in paragraph 23 of this paper). This is because the carrying amount will be fully deductible for tax purposes in future periods. Applying paragraph 8 of IAS 12 (also reproduced in paragraph 23), the tax

[2] Assuming the entity makes no lease payments before lease commencement.

base of the liability also equals its carrying amount. This is because the carrying amount will not be deductible for tax purposes in future periods. Tax deductions will be available for interest that the entity has not yet accrued at lease commencement. Accordingly, in this scenario temporary differences do not arise on initial recognition of the lease asset and lease liability, and thus the entity does not recognise any deferred tax at lease commencement.

32. To illustrate, we have used the example provided in the submission. Lessee rents a building for five years. The lease payments are CU100[3] per year, payable at the end of each year. Lessee's incremental borrowing rate is 5%. Lessee calculates the present value of the lease payments on initial recognition of the lease asset and lease liability as CU435. The lease payments are deductible for tax purposes on a cash basis.

33. The table below shows the carrying amount of the lease asset and lease liability over the 5-year lease term:

Lease liability, CU

	Opening carrying amount	Interest accrued	Payments	Closing carrying amount
Year 1	435	22	(100)	357
Year 2	357	17	(100)	274
Year 3	274	13	(100)	187
Year 4	187	9	(100)	96
Year 5	96	4	(100)	-
Total		**65**	**(500)**	

Lease asset, CU

	Opening carrying amount	Depreciation[4]	Closing carrying amount
Year 1	435	(87)	348
Year 2	348	(87)	261
Year 3	261	(87)	174
Year 4	174	(87)	87
Year 5	87	(87)	-
Total		**(435)**	

[3] CU = currency unit

[4] In this example, Lessee depreciates the asset on a straight-line basis over the 5-year lease term. We also assume there are no initial direct costs and no impairment of the lease asset during this period.

34. The tables above illustrate that the entity recognises total lease payments of CU500 in profit or loss over the 5-year period as depreciation of CU435 and interest expense of CU65. The tax deductions of CU500 relate to depreciation (CU435) and interest expense (CU65) and, thus, the tax base of the lease asset equals its carrying amount (CU435) on initial recognition. Accordingly, a temporary difference does not arise on initial recognition of the lease asset.

35. Tax deductions are not available in respect of the lease liability because the entity does not accrue interest on initial recognition of the lease liability. Tax deductions will be available in each of the 5 years of the lease when the entity accrues interest on the lease liability.

36. As illustrated, if the tax deductions relate to depreciation and interest expense, on initial recognition temporary differences do not arise on the lease asset or the lease liability. In subsequent periods, temporary differences will arise because the tax deductions obtained by the entity in each reporting period on a cash basis will not equal the total expense recognised by the entity in profit or loss. The following table illustrates this.

	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Total**
Depreciation	87	87	87	87	87	435
Interest expense	22	17	13	9	4	65
Total in P&L	**109**	**104**	**100**	**96**	**91**	**500**
Tax deduction	100	100	100	100	100	500
Difference	9	4	-	-4	-9	-

37. In Year 1, the entity recognises a total expense of CU109 (comprising CU87 depreciation and CU22 interest expense) whereas the tax deduction obtained equals the cash paid (CU100). Consequently, a temporary difference of CU9 arises. There is a question as to whether this difference relates to the lease asset or lease liability. In other words, how does the entity attribute the tax deduction obtained of CU100 for the lease payment made during the period? In our view, it will depend on the applicable tax law. We think it would be appropriate to allocate the tax deduction first to interest expense and then to depreciation if, in a particular tax jurisdiction, it is more common to have a temporary difference relating to depreciation than to interest. For example,

this might be the case if the amount of interest deductible for tax purposes is typically the same as the amount accrued in profit or loss.

38. Using this approach, in Year 1 the entity would allocate a tax deduction of CU22 to interest expense, and the remainder of CU78 (CU100 – CU22) to depreciation. Because depreciation recognised in profit or loss is CU87, the carrying amount of the lease asset at the end of Year 1 will be different from its tax base. A temporary difference therefore arises on the lease asset of CU9, as illustrated in the table below.

	Carrying amount of the lease asset[3]	Tax base of the lease asset[5]	Deductible temporary difference
Year 1	348	357	(9)
Year 2	261	274	(13)
Year 3	174	187	(13)
Year 4	87	96	(9)
Year 5	-	-	-

39. Depending on the applicable tax law, it might also be appropriate to allocate the tax deduction first to depreciation and then to interest. In this case, the carrying amount of the lease asset equals its tax base because the depreciation recognised in the profit or loss is the same as depreciation for tax purposes. The temporary difference of CU9 will therefore arise on the lease liability.

40. As mentioned above, this allocation will require judgement considering the applicable tax law. Nonetheless, we note that the carrying amount of the deferred tax asset recognised is unaffected by that judgement. In the example above, the temporary difference at the end of Year 1 is CU9, regardless of how the entity allocates it. The allocation affects only the disclosures required by paragraph 81 of IAS 12.

41. In this scenario—ie when an entity attributes tax deductions to the lease asset and future interest accrual, we note that the initial recognition exemption in paragraphs 15 and 24 of IAS 12 is not applicable because temporary differences do not arise on initial recognition of the lease asset and lease liability. Accordingly, the unit of

[5]The carrying amount of the lease asset at the end of Year 1 is calculated as follows: CU435 (the carrying amount on initial recognition) – CU87 (depreciation) = CU348.

The tax base of the lease asset at the end of Year 1 is calculated as follows: CU435 (the tax base on initial recognition) – CU78 (tax deduction related to depreciation) = CU357.

account considerations discussed in paragraphs 44-48 of this paper do not apply in this scenario.

42. This scenario also leads to the same outcome as that of Approach 2 and Approach 3 described in the submission, however the rationale is different. We do not support the rationale provided for Approach 2 and Approach 3 in the submission for the reasons provided in paragraphs 47 and 48 of this paper.

Tax deductions are attributable to the lease liability

43. Depending on the provisions of the applicable tax law, an entity might attribute the tax deductions to the repayment of the principal amount of the lease liability and the future interest accrual. In this case, applying paragraph 8 of IAS 12 the tax base of the liability is zero because the carrying amount of the liability will be fully deductible for tax purposes in future periods. Consequently, a temporary difference arises on initial recognition of the lease liability. Because the entity attributes no tax deductions to the lease asset, its tax base is zero. A temporary difference also therefore arises on the lease asset. Paragraphs 44–48 below analyse whether, in this scenario, an entity recognises a deferred tax asset and liability for those temporary differences, or whether the initial recognition exemption applies.

Unit of account in IAS 12—if temporary differences arise on the asset and liability at initial recognition

44. Assuming that temporary differences arise on the lease asset and lease liability at lease commencement (as in the scenario discussed in paragraph 43 above), an entity then considers whether to recognise a deferred tax asset and deferred tax liability for those temporary differences. To do so, an entity considers whether the initial recognition exemption in paragraphs 15 and 24 of the IAS 12 apply. If the initial recognition exemption does not apply, the entity would recognise a deferred tax asset and a deferred tax liability for the temporary differences.

45. Paragraphs 15 and 24 of IAS 12 state the following:

> 15. A deferred tax liability shall be recognised for all taxable temporary differences, except to the extent that the deferred tax liability arises from:

> (a) the initial recognition of goodwill; or
>
> (b) the initial recognition of an asset or liability in a transaction which:
>
> (i) is not a business combination; and
>
> (ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).
>
> ….
>
> 24. A deferred tax asset shall be recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised, unless the deferred tax asset arises from the initial recognition of an asset or liability in a transaction that:
>
> (a) is not a business combination; and
>
> (b) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

46. Paragraph 5 of IAS 12 defines temporary differences as differences between the carrying amount of an asset or liability *in the statement of financial position* and its tax base. Applying IFRS 16 and IAS 17, a lessee recognises a lease asset and lease liability in its statement of financial position. Therefore, in our view an entity considers the lease asset and lease liability independently of each other for the purposes of recognising deferred tax. The unit of account in IAS 12 is the separate asset and liability, and thus we think the initial recognition exemption would apply separately to the lease asset and lease liability that an entity recognises in its statement of financial position at lease commencement. Because the entity recognises a lease asset and lease liability at lease commencement, the transaction affects neither accounting profit nor taxable profit (tax loss). Consequently, in our view if an entity determines that temporary differences arise on initial recognition of the lease asset and lease liability, the initial recognition exemption applies and the entity would not recognise deferred tax. This reflects Approach 1 in the submission.

47. Applying Approach 2 in the submission, an entity would assess the lease asset and lease liability together as a single transaction because they are 'integrally linked'. Proponents of that approach say that it is consistent with the way in which the lease transaction is viewed for tax purposes. Although we agree that, for tax purposes, the tax authority considers the lease transaction to be a single item on which it gives a single set of tax deductions, we think there is no basis for this approach in IAS 12. This is because the requirements of IAS 12 focus separately on assets and liabilities recognised for accounting purposes.

48. Approach 3 in the submission says the initial recognition exemption in IAS 12 applies only when an entity recognises an asset *or* a liability. Because in the case of leases an entity recognises an asset *and* a liability at lease commencement, Approach 3 says the conditions underlying the initial recognition exemption are not present. An entity therefore recognises a deferred tax asset and deferred tax liability for the temporary differences that arise on initial recognition of the lease asset and lease liability on a gross basis. We do not agree with the premise underlying Approach 3. We think '*or*' within the phrase 'initial recognition of an asset or liability' in paragraphs 15 and 24 of IAS 12 merely means that the condition applies equally to assets *and* liabilities recognised for accounting purposes. It does not mean that in the single transaction an entity must recognise only an asset or a liability for the condition to apply.

Decommissioning liabilities

49. As mentioned in paragraph 9 of this paper, similar to leases an entity recognises a decommissioning liability and includes in the cost of an item of property, plant and equipment the costs of decommissioning the asset. The entity is likely to make payments to settle the decommissioning liability only at the end of the asset's useful life.

50. As discussed earlier in the paper in the context of a lease transaction, an entity needs to apply judgement having considered the applicable tax law to determine whether to attribute the tax deductions to the asset or the decommissioning liability. The accounting on initial recognition of a decommissioning liability is similar to the accounting for a lease—ie in both cases, on initial recognition an entity recognises an asset (that will be depreciated over the period of its use) and a liability typically for

the same amount. Accordingly, there are similar considerations in determining the tax base of the asset and decommissioning liability as there are for a lease—paragraphs 22-30 of this paper discuss those considerations in the context of a lease. If the entity attributes the tax deductions to the asset and the future interest expense, then temporary differences would not arise on initial recognition of the asset and decommissioning liability. Accordingly, the entity would not recognise a deferred tax asset or liability on initial recognition of the decommissioning asset and liability. In contrast, if the entity attributes the tax deductions to the settlement of the decommissioning liability, then temporary differences would arise on both the asset and the decommissioning liability. In that case, we think the entity would apply the initial recognition exemption in paragraphs 15 and 24 of IAS 12 and would not recognise a deferred tax asset or deferred tax liability (for the reasons outlined in paragraph 46 of this paper).

51. Because the accounting for decommissioning liabilities and leases are similar, it is likely that an entity would reach the same conclusions regarding the tax base of the asset and liability that the entity recognises for each transaction, having considered the applicable tax law. However, it is possible that an entity might reach different conclusions based on differences in the applicable tax law.

Staff Conclusion

52. The submission asks a question about the application of the initial recognition exemption in paragraphs 15 and 24 of IAS 12 to the temporary differences that are assumed to arise from the initial recognition of a lease asset and lease liability. However, in our view the question that first needs to be asked is whether temporary differences arise on initial recognition of that asset and liability. In making that assessment, an entity determines the tax base of the lease asset and lease liability. The entity applies judgement having considered the applicable tax law to determine the amount attributable to the lease asset and lease liability for tax purposes. Determining the attribution of the tax deductions to the lease asset or lease liability is not an accounting policy choice—an entity applies judgement having considered and analysed the applicable tax law.

53. If the entity attributes tax deductions to the lease asset and future interest accrual, temporary differences do not arise on initial recognition of the lease asset and lease liability and the initial recognition exemption does not apply. This outcome is the same as that of Approach 2 and Approach 3 described in the submission, however the rationale is different.

54. If the entity attributes tax deductions to the lease liability and future interest accrual, temporary differences arise on initial recognition of both the lease asset and lease liability. The initial recognition exemption in paragraphs 15 and 24 of IAS 12 apply and, thus, the entity does not recognise a deferred tax asset or deferred tax liability. This is because the initial recognition exemption applies separately to each asset and liability recognised in the statement of financial position. This outcome is the same as that of Approach 1 described in the submission.

Question 1 for the Committee
Does the Committee agree with our analysis of the requirements in IFRS Standards, summarised in paragraphs 52 - 54 of this paper?

Should the Committee add this matter to its standard setting agenda?

Is it necessary to add to or change IFRS Standards to improve financial reporting?[6]

55. Based on our analysis in paragraphs 21-54 of this paper, we think that the requirements in IAS 12 provide an adequate basis for an entity to account for the deferred tax consequences of leases and decommissioning liabilities in the fact pattern in the submission.

Staff recommendation

56. Based on our assessment of the Committee's agenda criteria in paragraphs 5.16-5.17 of the Due Process Handbook (discussed in paragraph 55 above), we recommend that

[6] Paragraph 5.16(b) of the *Due Process Handbook*.

the Committee does not add this matter to its standard-setting agenda. Instead, we recommend publishing an agenda decision that outlines how an entity applies the applicable requirements in IAS 12.

57. Appendix A to this paper outlines the proposed wording of the tentative agenda decision.

Questions 2 and 3 for the Committee
2. Does the Committee agree with our recommendation not to add this matter to its standard-setting agenda? 3. Does the Committee have any comments on the proposed wording of the tentative agenda decision outlined in Appendix A to this paper?

Appendix A – Proposed wording of the tentative agenda decision

IAS 12 *Income Taxes*: Deferred Tax—tax base of assets and liabilities

The IFRS Interpretations Committee (Committee) received a request about the recognition of deferred tax when a lessee (entity) recognises an asset and liability at the commencement date of a lease applying either IFRS 16 *Leases* or IAS 17 *Leases*. A similar question arises when an entity recognises a liability and includes in the cost of an item of property, plant and equipment the costs of decommissioning that asset. The request describes a fact pattern in which the lease payments and decommissioning costs are deductible for tax purposes when paid.[7]

Paragraphs 15 and 24 of IAS 12 require an entity to recognise a deferred tax asset or deferred tax liability for all temporary differences, subject to specific exemptions. One of those exemptions is that an entity does not recognise a deferred tax asset or a deferred tax liability to the extent that it arises from the initial recognition of an asset or liability in a transaction that is not a business combination and at the time of the transaction, affects neither accounting profit nor taxable profit. To determine whether to recognise deferred tax on initial recognition of the asset and liability in the fact pattern described in the request, an entity first assesses whether temporary differences arise.

Paragraph 5 of IAS 12 defines temporary differences as differences between the carrying amount of an asset or liability in the statement of financial position and its tax base. Paragraph 5 of IAS 12 also defines the tax base of an asset or liability as the amount attributed to that asset or liability for tax purposes. Accordingly, to assess whether temporary differences arise on initial recognition of the asset and liability, an entity considers the applicable tax law to determine the tax base of that asset and liability.

The Committee observed that depending on the applicable tax law, the entity might determine that the tax deductions are attributable to either:

[7] The term 'asset' in this [tentative] agenda decision refers to (i) a right-of-use asset recognised at the commencement date of a lease; or (ii) an item of property, plant and equipment for which the cost increases on initial recognition of a decommissioning liability. The term 'liability' in this [tentative] agenda decision refers to (i) a lease liability recognised at the commencement date of a lease; or (ii) a decommission liability recognised applying IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

(a) the asset, on the grounds that the deductions relate to the expenses arising from the transaction, ie for IFRS reporting purposes, depreciation and interest expense; or

(b) the liability, on the grounds that the deductions relate to the repayment of the principal amount of the liability and interest expense.

The Committee observed that when the applicable tax law allows tax deductions for cash payments, the tax authority does not necessarily regard those as deductions relating to an asset or liability—the tax authority is simply allowing tax deductions for specified cash outflows. In the fact pattern described in the request, an entity recognises those cash outflows in the statement of profit or loss as depreciation and interest expense. It is a matter of judgement, having considered the applicable tax law, whether an entity regards the tax deductions as:

(a) relating to depreciation and interest expense (and therefore attributable to the asset and future interest accrual); or

(b) relating to repayment of the principal amount of the liability and interest expense (and therefore attributable to the liability and future interest accrual).

The Committee noted that in many tax jurisdictions, repayment of the principal amount of a liability is not deductible for tax purposes. An entity more frequently receives tax deductions for the use of an asset (ie depreciation) and for interest payments on a liability. In these circumstances, the Committee would expect the entity to attribute the tax deductions received to the asset and future interest accrual. In contrast, in tax jurisdictions for which the repayment of the principal amount of a liability is deductible for tax purposes, the Committee would expect an entity to attribute the tax deductions to the liability and future interest accrual. The Committee observed that determining the attribution of the tax deductions to the asset or liability is not an accounting policy choice—an entity applies judgement having considered the applicable tax law.

When an entity attributes the tax deductions to the asset and future interest accrual, the tax base of the asset equals its carrying amount[8] applying paragraph 7 of IAS 12. This is because the carrying amount of the asset will be fully deductible for tax purposes in

[8] This assumes that the entity does not make any payments before initial recognition of the asset and liability.

future periods. Applying paragraph 8 of IAS 12, the tax base of the liability also equals its carrying amount. This is because the carrying amount of the liability will not be deductible for tax purposes in future periods. Tax deductions will be available for interest that the entity has not yet accrued on initial recognition of the asset and liability. Accordingly, in this scenario temporary differences do not arise on initial recognition of the asset and liability. Temporary differences may, however, arise after initial recognition.

When an entity attributes the tax deductions to the liability and future interest accrual, applying paragraph 8 of IAS 12 the tax base of the liability is zero because the carrying amount of the liability will be fully deductible for tax purposes in future periods. Because the entity attributes no tax deductions to the asset, its tax base is also zero. Accordingly, temporary differences arise on initial recognition of the asset and liability. In this scenario, therefore, the entity applies paragraphs 15 and 24 of IAS 12 to determine whether to recognise a deferred tax asset and deferred tax liability on initial recognition of the asset and liability.

The Committee observed that paragraphs 15 and 24 apply separately to assets and liabilities recognised in the statement of financial position, ie an entity is not permitted to consider the asset and liability recognised as a net amount. In the fact pattern described in the request, the entity recognises an asset and liability, and therefore the transaction affects neither accounting profit nor taxable profit (tax loss). Consequently, the initial recognition exemption in paragraphs 15 and 24 of IAS 12 applies, and in this scenario the entity does not recognise a deferred tax asset or deferred tax liability.

The Committee concluded that the principles and requirements in IAS 12 provide an adequate basis for an entity to determine whether to recognise a deferred tax asset or deferred tax liability in the fact pattern described in the request. Consequently, the Committee [decided] not to add this matter to its standard-setting agenda.

Appendix B – Submission

B1. We have reproduced the submission below. We have deleted details that would identify the submitter of this request.

Submission

B2. Under IFRS 16 *Leases*, a lessee recognises a right-of-use asset and a lease liability. In many jurisdictions, lease payments are tax-deductible on a cash basis. As a result, the tax base of the right-of-use asset is zero and the tax base of the lease liability is zero. This gives rise to a taxable temporary difference in relation to the right-of-use asset and a deductible temporary difference in relation to the lease liability.

B3. Similar considerations apply on initial recognition of a finance lease asset and finance lease liability under IAS 17 *Leases*. However, there is currently diversity in interpreting how the requirements in paragraphs 15 and 24 of IAS 12 *Income Taxes* related to the initial recognition exemption apply to finance lessees. We are concerned that this diversity will become more extensive with the introduction of IFRS 16.

B4. Three approaches are followed in practice (a detailed illustration of the approaches, including their impact on the financial statements and the effective tax rate, is included in [paragraphs B10 - B18 below]). We believe that without further clarifications, different approaches will continue to be used under IFRS 16. The three approaches can be summarised as follows.

B5. *Approach 1 – Initial recognition exemption applies:* Under this approach, the initial recognition exemption is applied separately to the lease asset and the lease liability. Because on initial recognition the lease transaction affects neither accounting nor taxable profit, there is no deferred tax accounting throughout the entire lease term. Instead, the temporary differences related to the lease asset and the lease liability impact the effective tax rate and are disclosed as reconciling items when explaining the relationship between tax expense and accounting profit. Supporters of this approach argue that paragraphs 15 and 24 of IAS 12 apply to each accounting asset and liability independently; the fact that in a lease the right-of-use asset and lease liability arise from the same transaction is not relevant. Conversely, opponents argue that under this approach, the primary financial statements do not reflect tax impacts of

leases, although most leases are priced based on the allocation of tax benefits between the lessee and the lessor, and some are structured to achieve specific tax effects.

B6. *Approach 2 – Finance lease asset and lease liability are 'integrally linked':* Under this approach, the lease asset and the lease liability are assessed together for the purpose of recognising deferred tax as a single transaction. Thus, there is no temporary difference on initial recognition. Temporary differences that arise subsequently as the lease asset is depreciated and the lease liability is reduced do not qualify for the exemption. As a result, the tax impact of the lease transaction is reflected in the primary financial statements and the effective tax rate more closely reflects the economics of the lease. Supporters of this approach argue that it is consistent with the way in which the lease transaction is viewed for tax purposes – i.e. as a single item – and that recognition of the right-of-use asset and lease liability are integrally linked – i.e. they are the two sides of a single double-entry. This approach meets the objective of IAS 12 to reflect the tax consequences of assets and liabilities. It also results in the relevant information for the users because it provides information that is capable of making a difference in their decision making process. Conversely, opponents believe that the fact that there is a single item for tax purposes is not relevant since paragraphs 15 and 24 of IAS 12 focus on the recognition of accounting assets and liabilities.

B7. *Approach 3 – Initial recognition exemption does not apply to the gross temporary differences:* Those who support this approach hold the view that the initial recognition exemption applies only when an asset *or* a liability is recognised. If there is a gross temporary difference, then the underlying conditions for the initial recognition exemption in paragraph 22(c) of IAS 12 are not present. Under this approach, the initial recognition exemption does not apply because an asset *and* a liability are recognised at the same time. The accounting outcome of this approach is similar to Approach 2 – i.e. the tax impact of a lease transaction is reflected in the primary financial statements.

B8. We note that this issue is also relevant to accounting for tax impacts of decommissioning provisions if they are deducted on a cash basis for tax purpose. Similar to accounting for leases by a lessee in accordance with IAS 17 and IFRS 16, under IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar*

Liabilities, an entity recognises a decommissioning liability and increases the carrying amount of the corresponding asset. This asset can be property, plant and equipment or a right-of-use asset accounted for under IFRS 16. The tax base of the liability is zero, as is the related portion of the asset. This gives rise to a deductible temporary difference in relation to the decommissioning provision and a taxable temporary difference in relation to the related portion of the asset. The same three approaches described above are applied in practice to account for deferred tax in respect of the decommissioning provisions.

B9. Therefore, we believe that the Interpretations Committee should address this issue because it could have a significant effect on the financial statements when the new leases standard becomes effective and consistency in this area is desirable. Unlike with some other matters of accounting diversity, reflecting or not reflecting something in the financial statements significantly affects comparability and the decision-making of users. Our assessment of this issue against the agenda criteria is included in [B19 - B23].

Example illustrating three approaches for applying the initial recognition exemption to lessee accounting

B10. Lessee T rents a building from Lessor L for five years. The lease commences on 1 January 2017. T agrees to pay CU100 per year at the end of each year. T's incremental borrowing rate is 5%. T calculates the following amounts for the right-of-use asset and the lease liability under IFRS 16.

Date	01-Jan-17	31-Dec-17	31-Dec-18	31-Dec-19	31-Dec-20	31-Dec-21
RoU asset	435	348	261	174	87	-
Lease liability	435	357	274	187	96	-

B11. On initial recognition of the lease, T records the following journal entry in its IFRS accounts:

	Debit	**Credit**
RoU asset	435	
Lease liability		435

B12. For tax purposes, the whole amount of the lease payment is deductible on a cash basis. Therefore, the following temporary differences arise on initial recognition.

	Carrying amount	**Tax base**	**Taxable (deductible) temporary difference**
RoU asset	435	0	435
Lease liability	(435)	0	(435)
Lease (net)	**0**	**0**	**0**

B13. T's tax rate is 50%. Before recognition of the lease, T's taxable income and IFRS profit before tax is CU500 per year.

Approach 1 – 'Initial recognition exemption' applies

B14. Under this approach, the temporary differences arising on initial recognition are considered separately. However, they are covered by the initial recognition exemption and therefore no deferred tax is recorded on initial recognition. Subsequent changes in the temporary differences are also covered by the initial recognition exemptions and therefore no deferred tax is recognised subsequently either.

B15. Approach 1 would have the following impacts on the IFRS statement of financial position, profit or loss and the effective tax rate.

Year	**2017**	**2018**	**2019**	**2020**	**2021**
Earnings before tax Taxable income (w/o lease)	500	500	500	500	500
Depreciation of RoU asset	87	87	87	87	87
Interest expense on lease liability	22	17	13	9	4
Earnings before tax	**391**	**396**	**400**	**404**	**409**
Lease expense	100	100	100	100	100
Taxable income	**400**	**400**	**400**	**400**	**400**
Tax expense	200	200	200	200	200
Effective tax rate	**51.2%**	**50.5%**	**50.0%**	**49.5%**	**48.9%**

Approach 2 – RoU asset and lease liability are 'integrally linked'

B16. Under this approach, the temporary difference for the net lease liability at initial recognition is zero. As the carrying amounts of RoU asset and lease liability are changing subsequently, temporary differences arise that would need to be accounted for.

	Carrying amount	**Tax base**	**Taxable (deductible) temporary difference**
1 January 2017			
RoU asset	435	0	435
Lease liability	(435)	0	(435)
Lease (net)	**0**	**0**	**0**
31 December 2017			
RoU asset	348	0	348
Lease liability	(357)	0	(357)
Lease (net)	**(9)**	**0**	**(9)**

	Carrying amount	**Tax base**	**Taxable (deductible) temporary difference**
31 December 2018			
RoU asset	261	0	261
Lease liability	(274)	0	(274)
Lease (net)	**(13)**	**0**	**(13)**
31 December 2019			
RoU asset	174	0	174
Lease liability	(187)	0	(187)
Lease (net)	**(13)**	**0**	**(13)**
31 December 2020			
RoU asset	87	0	87
Lease liability	(96)	0	(96)
Lease (net)	**(9)**	**0**	**(9)**
31 December 2021			
RoU asset	0	0	0
Lease liability	0	0	0
Lease (net)	**0**	**0**	**0**

B17. Approach 2 has the following impacts on the IFRS statement of financial position, profit or loss and the effective tax rate:

Year	2017	2018	2019	2020	2021
Earnings before tax Taxable income (w/o lease)	500	500	500	500	500
Depreciation of RoU asset	87	87	87	87	87
Interest expense on lease liability	22	17	13	9	4
Earnings before tax	**391**	**396**	**400**	**404**	**409**
Lease expense	100	100	100	100	100
Taxable income	**400**	**400**	**400**	**400**	**400**
Tax expense	195.5	198	200	202	204.5
Thereof deferred tax	(4.5)	(2)	(0)	2	4.5
Effective tax rate	**50.0%**	**50.0%**	**50.0%**	**50.0%**	**50.0%**

Approach 3 – 'Initial recognition exemption' does not apply

B18. The outcome of this approach is very similar to Approach 2. The main difference compared to Approach 2 is that deferred tax assets and deferred tax liabilities would be recognised on a gross basis and not on the net temporary differences. However, as those deferred tax assets and deferred tax liabilities will be offset in accordance with paragraph 74 of IAS 12, the main difference will be reflected in the disclosures in the notes.

Reasons for the Interpretations Committee to address the issues

B19. ***Is the issue widespread and practical?*** Yes. This issue is relevant for all lessees in a finance lease under IAS 17, and all lessees under IFRS 16 (unless they qualify for one of the recognition exemptions).

B20. ***Does the issue involve significantly divergent interpretations?*** Yes. The approach applied affects whether the tax impact of a lease transaction is reflected or not in the financial statements of lessees.

B21. ***Would financial reporting be improved through elimination of the diversity?*** Yes. The comparability of financial statements would be improved if all lessees apply the same accounting for deferred tax.

B22. ***Is the issue sufficiently narrow?*** Yes. It relates to the application of requirements in IAS 12 to specific transactions.

B23. ***If the issue relates to a current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project?*** No. a project on IAS 12 is not currently on the IASB agenda.

Summary of the Large Network positions in relation to IAS 17

B24. Below are the views of the Large Networks as we understand them [updated to reflect information provided to us after receiving the submission].

Approach	Outcome	KPMG	PwC	EY	DT
1. Initial recognition exemption applies	No accounting for tax consequences	✗	✓	✓	✓
2. Leased asset and lease liability are 'integrally linked'	Accounting for tax consequences (although no tax impact on initial recognition)	✓	✓	✓	✓
3. Initial recognition exemption does not apply to the gross temporary differences	Similar to Approach 2	✗	Not ruled out	✓	✗