STAFF PAPER

October 2020

IASB® meeting

Project	**Deferred Tax related to Assets and Liabilities arising from a Single Transaction (Amendments to IAS 12)**
Paper topic	Cover paper

CONTACT(S)	Gustavo Olinda	golinda@ifrs.org	+44 (0) 20 7246 6481
	Jawaid Dossani	jdossani@ifrs.org	+44 (0) 20 7332 2742

Introduction and purpose

1. In July 2019, the International Accounting Standards Board (Board) published the Exposure Draft *Deferred Tax related to Assets and Liabilities arising from a Single Transaction*, which proposed amendments to IAS 12 *Income Taxes* (Exposure Draft). The proposed amendments had been recommended by the IFRS Interpretations Committee (Committee) in response to a submission to the Committee.

2. In April 2020, the Board discussed a summary of the feedback on the Exposure Draft but was not asked to make any decisions at that stage.

3. In September 2020, we presented to the Committee our analysis and preliminary recommendations on how to address the matters raised in the feedback on the Exposure Draft. Our analysis and recommendations in the papers for this meeting take into account feedback from Committee members.

4. The purpose of this meeting is to:

    (a) provide the Board with our analysis and recommendations on how to address matters raised in the feedback on the Exposure Draft; and

    (b) ask the Board whether it agrees with our recommendations.

Structure of this paper and agenda papers for this meeting

5. This cover paper sets out the purpose of this meeting and includes:
   (a) a summary of our recommendations; and
   (b) an overview of the Exposure Draft.
6. We have included two agenda papers that summarise respondents' concerns and include our analysis of those concerns and recommendations:
   (a) Agenda Paper 12B considers feedback on the approach proposed in the Exposure Draft to address the accounting for deferred tax related to leases and decommissioning obligations.
   (b) Agenda Paper 12C considers feedback on the scope of the proposed amendments, transition requirements and other matters.
7. For ease of reference, Agenda Paper 12D reproduces materials from Agenda Papers 12G–I presented to the Board in April 2020.

Summary of recommendations

8. We recommend that the Board:
   (a) confirm its proposal to narrow the scope of the recognition exemption so that it would not apply to transactions that give rise to equal amounts of taxable and deductible temporary differences;
   (b) remove the capping proposal (ie not include the requirement to limit the recognition of a deferred tax liability to the extent that a deferred tax asset is recognised);
   (c) not provide application guidance or examples illustrating how an entity determines whether tax deductions relate to the lease asset or lease liability;
   (d) provide an illustrative example explaining the deferred tax accounting for advance lease payments and initial direct costs;
   (e) require entities already applying IFRS Standards to apply the amendments for the first time by:

(i) recognising deferred tax for all temporary differences related to leases and decommissioning obligations at the beginning of the earliest comparative period presented, with the cumulative effect recognised as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at that date; and

(ii) applying the amendments prospectively to transactions other than leases and decommissioning obligations (ie only to such transactions that occur on or after the beginning of the earliest comparative period presented); and

(f) require first-time adopters to recognise deferred tax for all temporary differences related to leases and decommissioning obligations existing at the date of transition to IFRSs, and provide no other requirements for first-time adopters.

Overview of the Exposure Draft

The general principle and recognition exemption in IAS 12

9. As a general principle, IAS 12 requires an entity to recognise deferred tax for all temporary differences. However, the Standard prohibits entities from recognising deferred tax assets or liabilities—both on initial recognition and subsequently—for deductible or taxable temporary differences arising on 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 (recognition exemption).

Accounting for deferred tax on leases and decommissioning obligations

10. Applying IFRS 16 *Leases*, an entity recognises an asset and liability at the commencement date of a lease. Similarly, applying IAS 16 *Property, Plant and Equipment* (or IFRS 16) and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, an entity recognises an asset and liability when it initially recognises a decommissioning obligation. In some cases, such transactions may give rise to temporary differences.

Determining whether tax deductions are attributable to the lease asset or lease liability

11. On initial recognition of a lease, an entity assesses whether temporary differences arise in determining whether to recognise deferred tax applying IAS 12.[1] In making this assessment, an entity determines the tax base of the right-of-use asset (lease asset) and the tax base of the lease liability by identifying the amounts attributable to them for tax purposes. When an entity receives tax deductions on making lease payments, the entity determines whether those tax deductions are attributable to:

    (a) the lease asset (and interest expense)—because the deductions relate to the expenses arising from the lease (that is, depreciation and interest expense); or

    (b) the lease liability (and interest expense)—because the deductions relate to the repayment of the lease liability and interest expense.

12. An entity applies judgement in determining whether tax deductions relate to the lease asset or lease liability, having considered the applicable tax law.

Accounting applying the existing requirements in IAS 12

13. Applying IAS 12, temporary differences arise on initial recognition only when the entity determines that tax deductions relate to the lease liability. This is because:

    (a) when tax deductions relate to the lease asset, the tax bases of the lease asset and lease liability equal their carrying amounts, reflecting that the entity will receive tax deductions equal to the carrying amount of the lease asset and receive no tax deductions in respect of the lease liability. Consequently, no temporary differences arise on initial recognition of the lease and the recognition exemption does not apply. The entity therefore recognises no deferred tax on initial recognition, but does so if and when temporary differences arise after initial recognition.

    (b) when tax deductions relate to the lease liability, the tax bases of the lease asset and lease liability are zero, reflecting that the entity will receive tax deductions in respect of the lease liability equal to its carrying amount and receive no tax

[1] For simplicity, paragraphs 11–19 explain the basis for the proposed amendments using leases as an example, but the explanation applies equally to other transactions such as decommissioning obligations.

deductions on recovering the carrying amount of the lease asset. Consequently, temporary differences arise on initial recognition of the lease and the recognition exemption applies. Accordingly, the entity recognises no deferred tax in respect of the lease (either on initial recognition or subsequently throughout the lease term).[2]

The purpose of the recognition exemption

14. Paragraph 22(c) of IAS 12 explains the purpose of the recognition exemption. If temporary differences arise on initial recognition of an asset or liability in a transaction that is not a business combination and affects neither accounting profit nor taxable profit, an entity would—in the absence of the exemption—recognise deferred tax and adjust the carrying amount of the asset or liability by the same amount. Such adjustments would make the financial statements less transparent and, for this reason, IAS 12 prohibits the recognition of deferred tax in these circumstances.

Is the recognition exemption needed for leases?

15. Assuming that an entity receives tax deductions when lease payments are made, on initial recognition of a lease asset and lease liability temporary differences would either:

    (a) not arise—because the tax deductions relate to the lease asset (see paragraph 13(a)); or

    (b) be equal and offsetting (that is, the resulting taxable and deductible temporary differences would be of the same amount)—because the tax deductions relate to the lease liability (see paragraph 13(b)).

16. Accordingly, when temporary differences arise, they are equal and offsetting. If the recognition exemption were not applied, an entity would generally recognise a deferred tax asset and liability of the same amount.[3] The recognition of a deferred tax asset and liability of the same amount would not require any adjustment to the carrying amount of the related lease asset or lease liability, nor would it have any

[2] This In brief article includes numeric examples illustrating the accounting when tax deductions relate to the lease asset and lease liability.

[3] Paragraph 18 of this paper explains situations in which equal taxable and deductible temporary differences might result in an entity recognising unequal amounts of deferred tax assets and liabilities.

effect on profit or loss. Thus, the outcome the recognition exemption was designed to prevent (see paragraph 14) does not apply to a lease and the exemption is not needed on initial recognition of a lease.

The approach proposed in the Exposure Draft (proposed approach)

Narrowing the scope of the recognition exemption

17. The Board decided to propose a narrow-scope amendment to IAS 12 that would narrow the scope of the recognition exemption so that it would not apply when an entity would otherwise recognise a deferred tax asset and liability of the same amount (ie the exemption would not apply when it is not needed). This approach would result in entities recognising deferred tax assets and liabilities for temporary differences arising on initial recognition of a lease. This in turn would result in an entity recognising the tax effects of a lease as it recovers the lease asset and settles the lease liability, thereby aligning the accounting for deferred tax related to leases with the general principle in IAS 12 (see paragraph 9).

The capping proposal

18. Paragraph 24 of IAS 12 requires an entity to recognise deferred tax assets only 'to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised' (recoverability requirement). Because of the recoverability requirement, in some situations equal taxable and deductible temporary differences might result in an entity recognising unequal amounts of deferred tax assets and liabilities.

19. To ensure entities recognise equal amounts of deferred tax assets and liabilities, the Board proposed that an entity would recognise a deferred tax liability only to the extent that it recognises a corresponding deferred tax asset applying the recoverability requirement (the capping proposal). The recognition exemption would therefore continue to apply to any portion of the deferred tax liability for which an entity recognises no corresponding deferred tax asset. If an entity were to recognise any such excess deferred tax liability, the entity would then need to adjust the carrying amount of the related asset as the other side of the entry. Recognising this portion of the deferred tax liability would result in the outcome the recognition exemption was designed to prevent.