STAFF PAPER

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Project	**Deferred Tax related to Assets and Liabilities arising from a Single Transaction (Amendments to IAS 12)**
Paper topic	Feedback Analysis—Proposed approach

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

Introduction

1. As discussed in Agenda Paper 12A for this meeting, this paper provides our analysis of the main comments received on the approach proposed in the Exposure Draft *Deferred Tax related to Assets and Liabilities arising from a Single Transaction*, as well as our recommendations for the International Accounting Standards Board (Board).

2. The analysis and recommendations in this paper take into account feedback from members of the IFRS Interpretations Committee (Committee). Appendix C includes a summary and analysis of that feedback.

Structure of the paper

3. This paper includes:

   (a) background; and

   (b) staff analysis and recommendations:

      (i) application of the capping proposal;

      (ii) attribution of tax deductions to the lease asset or lease liability; and

      (iii) advance lease payments and initial direct costs.

4. There are three appendices to this paper:

   (a) Appendix A—Diagram summarising the proposals and how our recommendations address the main concerns raised;

   (b) Appendix B—Analysis of alternative approaches considered; and

   (c) Appendix C—Summary and analysis of feedback from Committee members.

Background

5. Almost all respondents to the Exposure Draft agree with the Board's decision to address the accounting for deferred tax related to leases and decommissioning obligations. However, many of those respondents either disagree with, or express concerns about, a number of aspects of the proposals. Agenda Paper 12D includes further information about respondents' comments.

6. In this paper, we:

   (a) identify the main concerns raised by respondents on the proposed approach;

   (b) provide our analysis of those concerns, including consideration of alternative approaches proposed by respondents; and

   (c) set out our recommendations to the Board.

7. Appendix A includes a diagram summarising the proposed approach and at which stage within that approach respondents' main concerns arise, including cross-references to where those concerns are discussed in this paper.

Staff analysis and recommendations

8. As outlined in Agenda Paper 12D, respondents' main concerns on the proposed approach relate to the following matters:

   (a) the application of the capping proposal, including interaction with the recoverability requirement (see paragraphs 10–31 of this paper).

   (b) the attribution of tax deductions to the lease asset or lease liability (see paragraphs 32–37 of this paper).

(c) whether there are equal temporary differences on initial recognition—ie the treatment of advance lease payments and initial direct costs (see paragraphs 38–43 of this paper).

9. The following paragraphs analyse each of these matters.

Application of the capping proposal

Board's proposals and rationale

10. The Board proposed that, when equal and offsetting temporary differences arise on initial recognition of a transaction, an entity would recognise a deferred tax liability only to the extent that it recognises a deferred tax asset applying the recoverability requirement (capping proposal).[1] Paragraphs BC19–BC24 of the Exposure Draft explain that, if an entity were to recognise any excess deferred tax liability, it would have to adjust the carrying amount of the related asset as the other side of the entry, thus resulting in the outcome that the recognition exemption was designed to prevent.

Summary of respondents' concerns

11. Many respondents either disagreed with the capping proposal or expressed concerns about its application. These respondents said the capping proposal would:

(a) be complex and burdensome to apply, because:

(i) an entity would be required to assess the recoverability of each individual deferred tax asset on initial recognition of each applicable transaction—this would increase the frequency of such assessments (which can be complex), and give rise to practical challenges; and

(ii) if the entity were unable to recognise the deferred tax asset in full, it would be required to apply the recognition exemption to a portion of

[1] We refer to the requirement in paragraph 24 of IAS 12 that an entity recognises 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' as the 'recoverability requirement'.

the deferred tax liability—the resulting subsequent accounting would be complex and would also give rise to practical challenges.

(b) be inconsistent with the principles in IAS 12 *Income Taxes*, because the Standard generally requires an entity to recognise a deferred tax liability for all taxable temporary differences.

(c) not address situations in which an entity recognises different amounts of deferred tax assets and liabilities because different tax rates apply in future periods.

12. Some respondents also suggested developing application guidance and illustrative examples to help entities understand how to apply the capping proposal and to address some of the related questions (for example, questions about subsequent accounting). See paragraphs 7–27 of Agenda Paper 12D for more details.

Staff analysis

Complex and burdensome application

Assessing recoverability on initial recognition

13. As explained in paragraphs BC20–BC22 of the Exposure Draft, the Board noted that an entity might meet the recoverability requirement solely through the future reversal of taxable temporary differences arising from the same transaction (ie independently of other sources of taxable profits). This would be the case to the extent that (a) these taxable and deductible temporary differences reverse in the same period; or (b) the applicable tax law allows tax losses to be carried forward or back. The Board also noted that the patterns of reversal of taxable and deductible temporary differences arising for leases might often be similar, because lease payments are often made throughout the lease term as the lease asset is being depreciated.

14. We therefore expect that the recoverability assessment would not be complex in most cases, particularly on initial recognition of leases—entities would often be able to conclude that a deferred tax asset can be recognised in full on initial recognition with little analysis, especially if the entity is able to recognise deferred tax assets for all other deductible temporary differences. However, we acknowledge that making this

assessment for each applicable transaction could be complex if an entity has a history of tax losses and is unable to recognise all of its other deferred tax assets.

15. We also understand that, from a practical perspective, many entities assess the recoverability of deferred tax assets only at the reporting date. The capping proposal would require an entity to make this assessment on initial recognition of each applicable transaction.

Other complexities

16. Most of the complexities identified by respondents arise only when an entity is unable to recognise the deferred tax asset in full. In that case, we agree that the proposed approach could be complicated, for example:

   (a) an entity might need to partially apply the recognition exemption, and track separately temporary differences to which the exemption is applied from other temporary differences related to the same assets and liabilities.

   (b) in assessing the recoverability of deferred tax assets, it might be unclear how to allocate taxable temporary differences against particular deductible temporary differences and unused tax losses or credits.

   (c) it might be unclear how to account for the reassessment of unrecognised deferred tax assets after initial recognition, or account for subsequent changes in temporary differences when deferred tax is only partially recognised.

17. Many of these complexities and challenges already exist in other situations in which an entity applies the recognition exemption. However, we acknowledge that the proposed amendments could increase the frequency with which these complexities and application questions arise.

The principles underlying the recognition exemption

18. The Board's basis for the capping proposal was to retain the applicability of the recognition exemption when the recognition of a deferred tax liability would not be offset by the recognition of a deferred tax asset—this is because, in that case, without the exemption an entity would be required to adjust the carrying amount of the related asset (or recognise an income tax loss on initial recognition of the transaction).

19. However, applying the capping proposal, an entity would not recognise a deferred tax liability only when it could not recover the corresponding deferred tax asset—this circumstance is particular to the entity and not particular to the tax characteristics of the transaction (which is the case for other transactions to which the recognition exemption applies). Therefore, applying the recognition exemption solely on that basis does not align with other circumstances in which the exemption applies.

Different tax rates applying in future periods

20. Some respondents said, applying paragraph 47 of IAS 12, an entity may recognise different amounts of deferred tax assets and liabilities on initial recognition if different tax rates apply in future periods when the temporary differences reverse—this could be the case even if there are equal amounts of taxable and deductible temporary differences and the recoverability requirement is met. In these circumstances, the deferred tax asset recognised may be greater than the deferred tax liability, which would result in an entity recognising a tax gain on initial recognition or adjusting the carrying amount of the related liability.[2]

21. Although respondents did not comment on the prevalence of such circumstances, or whether the effects are expected to be material, we acknowledge that the capping proposal would not avoid the outcome the recognition exemption was designed to prevent in such circumstances.

22. Further, in these circumstances the capping proposal could result in the recognition exemption applying only to a small portion of the resulting deferred tax (ie only to any difference arising from different tax rates), thus resulting in complexity—for example, by requiring an entity to subsequently track the small portion of deferred tax to which the recognition exemption applied.

Possible ways to address respondents' concerns

23. Based on our analysis in paragraphs 13–22 above, we considered whether and how the Board could modify its proposals in a way that addresses respondents' concerns—

[2] The amount of deferred tax assets may also be smaller than the amount of deferred tax liabilities. In this case, the capping proposal would avoid the recognition of a tax loss.

in particular concerns about the complexity of applying the capping proposal—while still achieving the objectives of the proposals.

24. We considered the approaches suggested by respondents and conducted outreach with preparers of financial statements that responded to the Exposure Draft to better understand the practical challenges of applying these approaches. Paragraphs 25–30 below discuss our recommendation for the Board and Appendix B discusses the approaches we considered but have not recommended.

Our recommended approach

25. In our view, the approach that best achieves the objective of the proposed amendments while appropriately balancing expected benefits and costs is one that confirms the proposed approach but removes the capping proposal (the recommended approach). In other words, the recommended approach would:

    (a) specify that an entity does not apply the recognition exemption when a transaction gives rise to equal amounts of taxable and deductible temporary differences; but

    (b) remove the requirement to limit the recognition of a deferred tax liability to the extent a deferred tax asset is recognised.

26. In our view this approach would have the following benefits:

    (a) *reduce the complexity of the proposed approach*—by removing the capping proposal, the recommended approach would solve the complexity concerns discussed in paragraphs 13–17 of this paper. In particular, the recommended approach would:

        (i) not require an entity to assess recoverability on initial recognition of applicable transactions to determine the extent to which a deferred tax liability can be recognised.

        (ii) result in the recognition exemption applying to fewer transactions than would be the case applying the proposed amendments, and avoid the need to track separately temporary differences related to the same assets and liabilities (which would be the case if the recognition exemption applied only partially).

(iii) be simpler and less costly to apply than the approach proposed in the Exposure Draft and other alternatives proposed by respondents. Feedback on the Exposure Draft indicates that the proposed approach would create a significant amount of complexity to address outcomes that occur only in limited circumstances.

(b) *conceptually sound*—in our view, for transactions that give rise to equal amounts of taxable and deductible temporary differences, removing the capping proposal would be consistent with the objective of the proposed amendments and the general principles in IAS 12—ie an entity would recognise deferred tax for all temporary differences—and with other situations in which the recognition exemption applies (see paragraph 19 of this paper).

(c) *avoid unintended consequences*—some of the alternative approaches we explored had the potential to create unintended consequences because they would introduce exceptions to the general principles in IAS 12 (see Appendix B). The recommended approach however would simply require entities to apply the general principles in IAS 12 to transactions within the scope of the amendments.

(d) *least disruptive for preparers*—we understand entities have adopted differing approaches to accounting for deferred tax when first applying IFRS 16 (see paragraph B8 of this paper). Therefore, any approach that the Board develops would cause disruption for some preparers. Nonetheless, we think an approach that would require application of the general principles in IAS 12—which entities already apply to other assets and liabilities—would be less disruptive for preparers than prescribing new requirements that would apply only to transactions within the scope of the amendments. Some of the alternative approaches we considered would have prescribed new requirements.

Recognition of unequal amounts of deferred tax assets and liabilities

27. As discussed in paragraphs 18–19 of this paper, removing the capping proposal could result in an entity recognising unequal amounts of deferred tax on initial recognition of a transaction that gives rise to equal and offsetting temporary differences. Applying

the recommended approach, an entity would recognise any difference in profit or loss for the period.[3] This would be the case if:

(a) an entity is unable to recognise a deferred tax asset because it does not meet the recoverability requirement, but is required to recognised a deferred tax liability; or

(b) the deferred tax asset and liability differ because different tax rates apply in future periods when the temporary differences reverse.

We consider these two situations in the following paragraphs.

An entity is unable to recognise a deferred tax asset

28. As explained in paragraph 19 above, if an entity recognises a deferred tax liability but is unable to recognise an equal and offsetting deferred tax asset, this reflects the fact that the entity expects to be unable to benefit from the tax deductions related to the transaction; it does not represent a circumstance in which the recognition exemption would otherwise apply. Removing the capping proposal would therefore be consistent with the principles in IAS 12 (including those that underpin the recognition exemption).

29. Further, we expect that unequal amounts of deferred tax would arise on initial recognition only infrequently, because:

(a) situations in which an entity would be unable to recognise deferred tax for leases are expected to be limited (for the reasons explained in paragraph 13 of this paper); and

(b) for decommissioning obligations, because these obligations often involve large amounts, we would expect most entities to make efforts to ensure they can benefit from any tax deductions, for example through tax planning opportunities.

[3] Paragraph 58 of IAS 12 requires an entity to recognise deferred tax as income or an expense and include it in profit or loss for the period, except to the extent it arises from (a) a transaction or event recognised outside profit or loss, or (b) a business combination.

Differences in the measurement of deferred tax assets or liabilities

30. We expect (a) situations in which different tax rates apply in future periods to exist only in a limited number of jurisdictions; and (b) the net effect of applying different tax rates to often be immaterial. Further, as discussed in paragraph 22, we think applying the recognition exemption in these situations would add complexity and, therefore, the expected benefits of doing so would not outweigh the costs.

Staff recommendation

31. Based on our analysis above in paragraphs 13–30, 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; and

    (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).

Attribution of tax deductions to the lease asset or lease liability

Board's proposal and rationale

32. Paragraphs BC5–BC6 of the Exposure Draft explain that, on initial recognition of a lease, IAS 12 requires an entity to determine the tax base of the lease asset and lease liability.[4] In doing so, the entity determines whether tax deductions received on making lease payments are attributable to the lease asset or lease liability. An entity applies judgement in determining whether tax deductions relate to the lease asset or lease liability, having considered the applicable tax law. The Board considered but decided not to propose further requirements on how to make this determination.

[4] For simplicity, the basis for conclusion on the proposed amendments and our analysis in this paper uses leases as an example, but the explanation applies equally to other transactions such as decommissioning obligations.

Summary of respondents' concerns

33. Some respondents suggested providing application guidance or illustrative examples to help entities assess whether tax deductions are attributable to the lease asset or lease liability. Some of these respondents noted that the proposed amendments would improve consistency in amounts recognised in profit or loss. However, they said differences in the recognition and disclosure of deferred tax would continue depending on whether an entity attributes tax deductions to the lease asset or lease liability. See paragraphs 28–32 of Agenda Paper 12D for more details.

Staff analysis

34. In developing the proposals, the Board noted that the proposed amendments would result in entities recognising deferred tax assets and liabilities for temporary differences that arise (on initial recognition and subsequently) in relation to a lease, regardless of whether tax deductions are attributable to the lease asset or lease liability. Further, an entity would typically offset these deferred tax assets and liabilities in its statement of financial position (applying paragraphs 74–75 of IAS 12). Therefore, the Board considered it unnecessary to provide further application guidance on the attribution of tax deductions to the lease asset or lease liability. Developing such application guidance would not be straight-forward.

35. Respondents have not provided information on this matter that the Board did not consider in developing the proposed amendments. The Board was aware of the different outcomes that follow from the way an entity attributes tax deductions. In particular, the Board was aware that paragraph 81(g) of IAS 12 requires disclosures of deferred tax by each type of temporary difference. Applying this requirement, an entity that attributes tax deductions to the lease liability would disclose two temporary differences associated with the lease asset and lease liability, while an entity that attributes tax deductions to the lease asset would disclose a single temporary difference associated with the lease asset.

36. Further, we acknowledge that (a) entities that attribute tax deductions to the lease liability would recognise larger amounts of deferred tax assets than those that attribute tax deductions to the lease asset—those entities could, therefore, have larger

exposures to losses that might result from reassessing the recoverability of deferred tax assets; and (b) entities might make different judgements about the attribution of tax deductions. Nonetheless, we continue to agree with the Board's proposal not to provide further requirements regarding the attribution of tax deductions to the lease asset or lease liability. We think the benefits of providing further requirements would not outweigh the potential costs because:

(a) there is significant risk of unintended consequences—such requirements could unintentionally affect how entities interpret tax laws to determine the tax base of assets and liabilities in other situations;

(b) providing such requirements would add complexity, and is unnecessary to achieve the objective of the proposed amendments;

(c) the existence of equivalent amounts of taxable temporary differences when an entity attributes tax deductions to the lease liability would, in most cases, support the recognition of deferred tax assets; and

(d) the potential differences in disclosure alone are not significant enough, in our view, to warrant developing further requirements in this area.

Staff recommendation

37. Based on our analysis in paragraphs 34–36 above, our recommendation is that the Board not provide further requirements on the attribution of tax deductions to the asset or liability.

Advance lease payments and initial direct costs

Board's proposal and rationale

38. Paragraphs BC16–BC18 of the Exposure Draft explain why the Board concluded that advance lease payments and initial direct costs would not affect the proposed amendments. The Board observed that making advance lease payments or paying initial direct costs do not give rise to equal and offsetting temporary differences and, therefore, an entity would apply the existing requirements in IAS 12 to any temporary

difference arising from such payments. For example, if tax deductions are received when lease payments are made, an entity that makes an advance lease payment recognises an asset and receives a tax deduction at the time it makes that payment. Because the transaction affects the entity's taxable profit, the recognition exemption would not apply, and the entity would recognise deferred tax for any temporary difference associated with the asset.

Summary of respondents' concerns

39. Some respondents suggested providing examples or further explanation about the accounting for deferred tax related to advance lease payments and initial direct costs, for example by including the explanation in paragraphs BC16–BC18 as application guidance in IAS 12. A few respondents said the proposal would require an entity to track separately advance lease payments and initial direct cost components of a lease asset. See paragraphs 33–36 of Agenda Paper 12D for more details.

Staff analysis

40. We disagree with respondents that said the proposed amendments would require an entity to track separately advance lease payments and initial direct cost components of an asset. Applying the proposed amendments:

    (a) the recognition exemption would not apply to equal and offsetting temporary differences arising from the recognition of a lease liability and the related component of a lease asset—accordingly, an entity would apply the requirements in IAS 12 and recognise deferred tax for any resulting temporary differences; and

    (b) similarly, the entity would apply the requirements in IAS 12 for any temporary differences arising when an entity makes advance lease payments or pays initial direct costs.

41. Accordingly, the entity would recognise deferred tax for the entire temporary difference associated with the lease asset, meaning that separate tracking of individual

components would be unnecessary.[5] Paragraphs BC16–BC18 of the Exposure Draft explains only that the proposed amendments apply to leases even if an entity makes advance lease payment or pays initial direct costs.

42. Nonetheless, we agree with respondents that suggested it could be helpful to provide an illustrative example to explain the above. Doing so could help stakeholders' understanding of the proposed amendments.

Staff recommendation

43. Based on our analysis above in paragraphs 40–42, we recommend that the Board provide an illustrative example explaining the deferred tax accounting for advance lease payments and initial direct costs.

Summary of recommendations

44. 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);

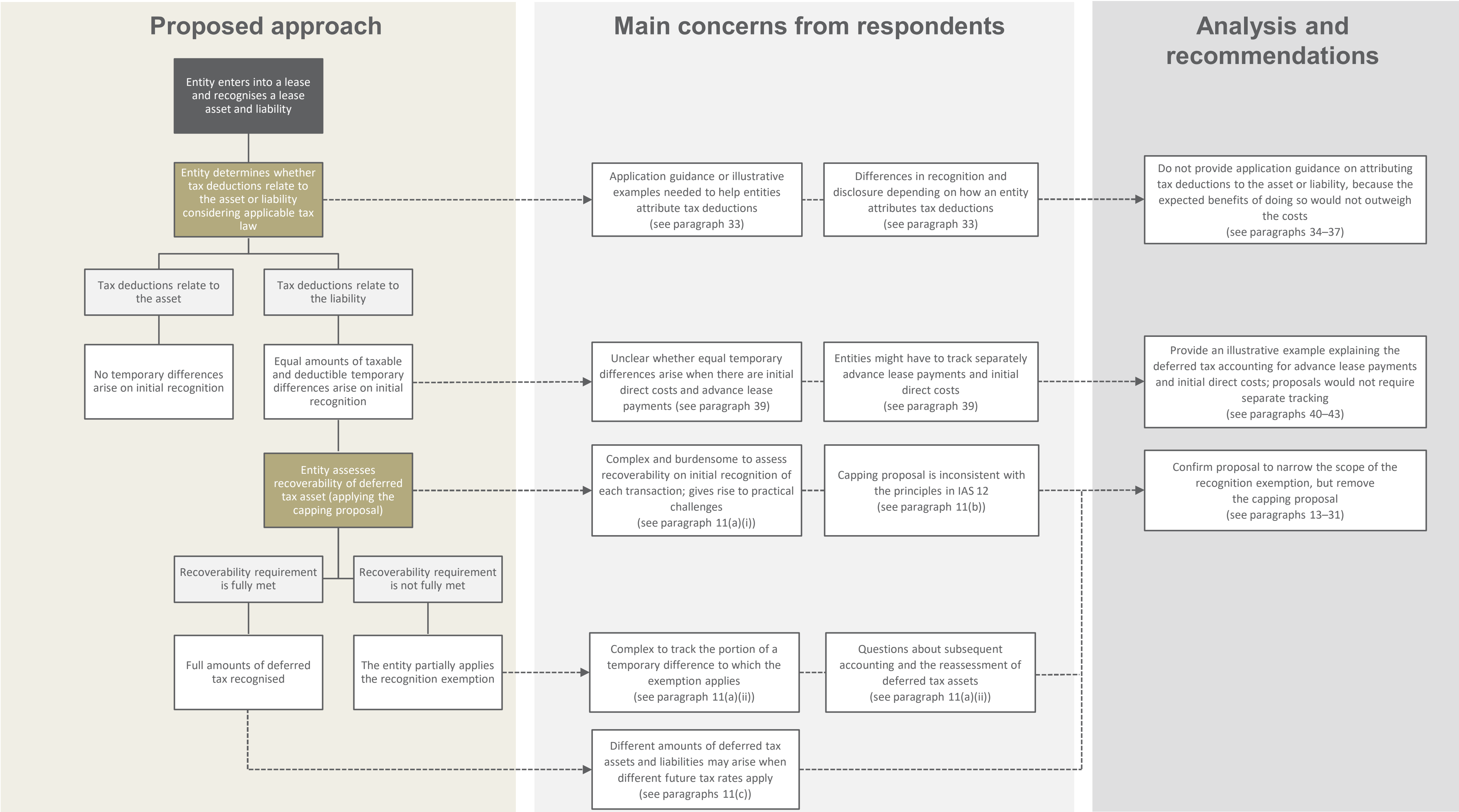
    (c) not provide application guidance or examples illustrating how an entity determines whether tax deductions relate to the lease asset or lease liability; and

    (d) provide an illustrative example explaining the deferred tax accounting for advance lease payments and initial direct costs.

[5] This assumes that entities receive tax deductions for advance lease payments and initial direct costs either immediately or in the future. If the entity receives no tax deductions for such transactions, then the recognition exemption would apply in the same way it does for any other non-deductible portion of an asset.

Question for the Board
Does the Board agree with the recommendations set out in paragraph 44 of this paper?

Appendix A—Diagram summarising the proposals and how our recommendations address the main concerns raised



Proposed approach
Main concerns from respondents
Analysis and recommendations
Entity enters into a lease and recognises a lease asset and liability
Entity determines whether tax deductions relate to the asset or liability considering applicable tax law
Application guidance or illustrative examples needed to help entities attribute tax deductions (see paragraph 33)
Differences in recognition and disclosure depending on how an entity attributes tax deductions (see paragraph 33)
Do not provide application guidance on attributing tax deductions to the asset or liability, because the expected benefits of doing so would not outweigh the costs (see paragraphs 34–37)
Tax deductions relate to the asset
Tax deductions relate to the liability
No temporary differences arise on initial recognition
Equal amounts of taxable and deductible temporary differences arise on initial recognition
Unclear whether equal temporary differences arise when there are initial direct costs and advance lease payments (see paragraph 39)
Entities might have to track separately advance lease payments and initial direct costs (see paragraph 39)
Provide an illustrative example explaining the deferred tax accounting for advance lease payments and initial direct costs; proposals would not require separate tracking (see paragraphs 40–43)
Entity assesses recoverability of deferred tax asset (applying the capping proposal)
Complex and burdensome to assess recoverability on initial recognition of each transaction; gives rise to practical challenges (see paragraph 11(a)(i))
Capping proposal is inconsistent with the principles in IAS 12 (see paragraph 11(b))
Confirm proposal to narrow the scope of the recognition exemption, but remove the capping proposal (see paragraphs 13–31)
Recoverability requirement is fully met
Recoverability requirement is not fully met
Full amounts of deferred tax recognised
The entity partially applies the recognition exemption
Complex to track the portion of a temporary difference to which the exemption applies (see paragraph 11(a)(ii))
Questions about subsequent accounting and the reassessment of deferred tax assets (see paragraph 11(a)(ii))
Different amounts of deferred tax assets and liabilities may arise when different future tax rates apply (see paragraphs 11(c))

Appendix B—Analysis of alternative approaches considered

B1. This appendix considers the alternative approaches suggested by respondents (see paragraphs 44–51 of Agenda Paper 12D for further information) and explains why we have not recommended them. In particular, this appendix discusses:

(a) the ‘net’ approach and the ‘attribution’ approach (see paragraphs B2–B13);

(b) the ‘readily determinable’ approach (see paragraphs B14–B18);

(c) confirming the proposed amendments and providing application guidance (see paragraphs B19–B20);

(d) developing an interpretation (see paragraphs B21–B25); and

(e) a broader review of IAS 12 or removal of the recognition exemption (see paragraphs B26–B27)

The ‘net’ approach and the ‘attribution’ approach

Description of the approach

B2. The Board could propose an approach for which no temporary differences would arise on initial recognition of a lease or decommissioning obligation. This would not only resolve the question of whether the recognition exemption applies (because there would be no temporary differences to which the recognition exemption might apply) but it would also make the capping proposal unnecessary. Such an approach would result in an entity recognising deferred tax for any temporary differences that arise after initial recognition.

B3. Respondents suggested two approaches that would achieve this outcome:

(a) the *net approach*—this approach would specify that an entity recognises deferred tax only for the ‘net’ amount of the temporary differences associated with the asset and liability. Because the temporary differences are equal and offsetting at initial recognition, there would be no ‘net’ temporary difference at that date.

(b) the *attribution approach*—this approach would specify that an entity attributes tax deductions to the asset. When tax deductions relate to the asset, the tax bases of the asset and liability will equal their carrying amounts, reflecting that the entity will receive tax deductions equal to the carrying amount of the asset and receive no deductions for the liability. Accordingly, no temporary differences arise on initial recognition.[6]

B4. In addition to the advantages noted in paragraph B2, both of these approaches would address concerns related to the attribution of tax deductions (see paragraph 33 of this paper). This is because these approaches would either require a specific attribution (attribution approach) or make that attribution irrelevant (net approach).

B5. The proposed approach in the Exposure Draft would narrow the recognition exemption and therefore was consistent with the principles in IAS 12. However, both the net approach and the attribution approach would be exceptions to the principles in IAS 12—the net approach would require an entity to consider temporary differences on a net basis (whereas IAS 12 otherwise requires an entity to consider individual temporary differences), while the attribution approach would require a prescribed attribution regardless of the applicable tax law.

B6. These approaches would also have some additional disadvantages, for example:

(a) the *net approach* may be costly and difficult to implement if accounting systems are set up to deal with each temporary difference separately.

(b) it may be difficult to determine the tax base of the asset applying the *attribution approach* after initial recognition (eg an entity would be required to allocate tax deductions received between interest expense and depreciation). Entities that currently attribute tax deductions to the liability might find this approach complicated to implement and apply.

Additional outreach with preparers

B7. To better understand the practical and operational aspects of applying the net approach and the attribution approach, and to confirm whether these approaches would be simpler and less costly to apply than the approach proposed in the Exposure Draft, we held outreach meetings with a number of preparers of financial statements

[6] This article explains, via a numerical example, why no temporary differences arise on initial recognition when tax deductions are attributable to the asset.

that responded to the Exposure Draft. These respondents represented five large multi-national companies operating in different sectors, including industries in which entities enter into large volumes of leases and incur decommissioning obligations.

B8. The preparers applied different approaches in accounting for deferred tax when they first applied IFRS 16. For example:

(a) one preparer applies an accounting policy in which the recognition exemption does not apply to leases;

(b) one preparer attributes the tax deductions to the lease asset (ie similar to the attribution approach); and

(c) another preparer considers the lease asset and lease liability to be 'linked' and recognises deferred tax only for the net temporary difference arising (ie similar to the net approach).

B9. Preparers emphasised the need for simplicity in any approach the Board requires. Although the preparers generally preferred one or both of the net approach or the attribution approach over the proposed amendments, they expressed mixed views about which of the two approaches they preferred—a few preferred the net approach, a few the attribution approach, and a few suggested that the recognition exemption not apply (for example, by removing the capping proposal or removing IAS 12's recognition exemption altogether).

B10. A few preparers were concerned about the practical and operational aspects of applying either the net approach or the attribution approach, while others said either or both of the approaches are unlikely to be onerous to implement. For example:

(a) one preparer said it could be costly and difficult to apply the net approach, particularly if an entity has a large number of leases. This is because applying the net approach would require linking specific assets and liabilities, which could be managed in different systems. In contrast, another preparer said it uses spreadsheets to calculate and consolidate deferred tax across many of the countries in which it operates, so applying the net approach would not be overly difficult.

(b) one preparer said it would be difficult to apply the attribution approach—particularly for decommissioning obligations—because the amounts expected to settle the provision are regularly re-estimated, resulting in changes to the tax base of the asset. Another preparer said the attribution approach would be simpler and less costly to apply than both the net approach and the proposed amendments.

B11. Some preparers also expressed concerns about unintended consequences that might result from either of these approaches because they would be exceptions to the principles in IAS 12.

Reasons not to proceed with the net approach or the attribution approach

B12. Both the *net approach* and the *attribution approach* would address many of the concerns raised by respondents—in particular, these approaches would remove the complexity arising from the capping proposal, and would result in no deferred tax asset or liability being recognised on initial recognition of the transaction.

B13. However, the limited outreach we performed indicates that both could be complex and costly to apply, depending on the systems and processes entities have in place for leases and decommissioning obligations. These approaches would also introduce exceptions to the general principles in IAS 12. Accordingly, these approaches:

(a) could require changes to the current processes entities apply to account for deferred tax; and

(b) risk unintended consequences because of (i) entities inappropriately applying a similar approach to other assets and liabilities, or (ii) interactions with other requirements in IAS 12 or other IFRS Standards.

‘Readily determinable’ approach

Description of the approach

B14. The proposed amendments would apply when equal amounts of taxable and deductible temporary differences arise on initial recognition of a transaction and, therefore, it might often be readily determinable that the recoverability requirement is met (see paragraphs 13–14 of this paper). Accordingly, the Board could modify its proposals so that the recognition exemption would not apply when it is ‘readily determinable’ that the recoverability requirement is met on initial recognition. This would remove the need for an entity to perform a detailed recoverability assessment on initial recognition and could remove many of the complexities respondents identified.

B15. Applying this approach, the recognition exemption would continue to apply when it is not readily determinable that the recoverability requirement is met.

Reasons not to proceed with the readily determinable approach

B16. Although this approach would reduce complexity by not requiring entities to perform a detailed recoverability assessment on initial recognition, it would introduce a new concept in the context of accounting for deferred tax (‘readily determinable’). This could add complexity and lead to application questions.

B17. This approach could also result in the recognition exemption being applied in more situations than would be the case applying the proposed amendments. This is because the recognition exemption would continue to apply when it is potentially unnecessary—for example, an entity would apply the recognition exemption to a transaction for which the related deferred tax asset *is* recoverable, but its recoverability is not readily determinable. As discussed in paragraphs 16–17 of this paper, applying the recognition exemption can be complex.

B18. Importantly, the approach might also reduce the understandability of the resulting information because the recognition exemption would apply to some transactions but not to other similar transactions.

Confirm proposed amendments and provide application guidance

Description of the approach

B19. The Board could confirm the proposed approach in the Exposure Draft, and provide application guidance to address some of the concerns raised. For example, the Board could provide application guidance explaining the subsequent accounting for any deferred tax asset or liability not recognised on initial recognition.

Reasons not to proceed with the proposed amendments

B20. Application guidance alone would be unable to address many of the concerns respondents raised about the complexity of the proposed approach, and in particular the capping proposal. It would also be difficult to develop such application guidance in a way that would not raise further questions or complexity. In our view, respondents' concerns can be addressed more effectively using other approaches whilst still achieving the main objectives of the proposals.

Developing an Interpretation

Description of the approach

B21. The Board could address the matter through an interpretation. One respondent said most entities currently apply IAS 12 either:

(a) separately to the asset and liability—in which case the recognition exemption applies and no deferred tax is recognised (on initial recognition or subsequently); or

(b) to the transaction as a whole—in which case deferred tax is not recognised on initial recognition, but is recognised subsequently as the carrying amount of the asset and liability changes (similar to the 'net approach' described in paragraph B3(a) above).

B22. The respondent said diversity in reporting could be reduced by prescribing one of these methods through an interpretation.

Reasons not to proceed with an interpretation

B23. In developing the proposed amendments, the Board considered whether to address the matter through an interpretation but decided not to. Any interpretation would retain the current scope of the recognition exemption, and therefore could result in different accounting treatments depending on whether an entity attributes the tax deductions to the asset or liability.

B24. As discussed in BC15(b) of the Exposure Draft, the Board concluded that while developing an interpretation could reduce differences in the accounting for similar transactions, the approach would retain an accounting outcome that is not aligned with the general principles in IAS 12—the recognition exemption would continue to apply in situations in which is it not needed (that is, when tax deductions are attributable to the lease liability).

B25. Further, we think it would not be possible to develop an interpretation, as suggested by the respondent, that would allow an entity to apply IAS 12 to the transaction as a whole. We think doing so would require an amendment to IAS 12 in a similar way as the 'net approach' (see paragraphs B2–B13 of this paper).

Broader review of IAS 12 or removal of the recognition exemption altogether

Description of the approach

B26. Some respondents said the proposed amendments highlight broader concerns about the application of IAS 12, particularly the recognition exemption. Some of these respondents suggested removing the recognition exemption altogether, while a few others suggested undertaking a comprehensive review of IAS 12.

Reasons not to proceed with a broader review at this time

B27. Removing the recognition exemption altogether or considering whether to undertake a broader review of IAS 12 is beyond the scope of these narrow-scope amendments. To the extent there is a narrow-scope solution available to address deferred tax related to leases and decommissioning obligations, in our view the Board should proceed with it—as discussed earlier, almost all respondents supported addressing the accounting for deferred tax related to leases and decommissioning obligations.

Appendix C—Summary and analysis of feedback from Committee members

Background

C1. 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. The following paragraphs include a summary of feedback from Committee members on the matters addressed in this paper and our analysis of that feedback.

Recommended approach

Summary of comments

C2. All Committee members agreed with, or did not oppose, the recommended approach (ie removing the capping proposal). Some Committee members said the recommended approach:

(a) is a reasonable, practical and pragmatic solution that addresses respondents' concerns; and

(b) would reduce the complexity of the proposals, while still achieving the objective of the proposed amendments.

Providing application guidance on attribution of tax deductions

Summary of comments

C3. Some Committee members said it would be helpful to provide application guidance to help entities determine whether tax deductions relate to the lease asset or lease liability. One Committee member said removing the capping proposal would make attribution more sensitive.[7] Another Committee member said the Board could simply specify that the deductions relate to the lease liability.

[7] This is because an entity might recognise a loss if tax deductions are attributable to the lease liability that it would not recognise if tax deductions were attributable to the lease asset. This would be the case if the entity is unable to recognise the deferred tax asset in full.

C4. However, other Committee members said, although application guidance could be helpful, they understand the reasons for not developing such guidance. Some of these Committee members said:

(a) it would be exceedingly difficult to develop application guidance given the different facts and circumstances that apply to each particular tax jurisdiction;

(b) any application guidance would have to (i) encompass different tax jurisdictions; and (ii) describe the underlying tax legislation in the context of a particular jurisdiction;

(c) entities are already required to interpret tax legislation in applying other requirements in IAS 12; and

(d) stakeholders in a particular jurisdiction should be able to reach consensus on how to attribute tax deductions based on the particular tax legislation and circumstances in that jurisdiction.

Staff analysis

C5. Committee members' comments indicate that it might not be feasible or desirable for the Board to provide application guidance on attributing tax deductions. Further, for the reasons explained in paragraphs 34–36 of this paper, we continue to think the expected benefits of providing such guidance would not outweigh the costs of doing so.

Measurement differences when different tax rates apply

Summary of comments

C6. One Committee member said, although he understands the rational for removing the capping proposal when an entity is unable to recognise a deferred tax asset in full, it is unclear why the recognition exemption should not apply when different amounts of deferred tax assets and liabilities are recognised because differing tax rates apply in future periods. Nonetheless, he said removing the capping proposal is (a) not unreasonable in the context of this narrow-scope project; (b) is consistent with general principles in IAS 12; and (c) aligns with the objective of narrowing the scope of the recognition exemption.

C7. Another Committee member said he had a similar conceptual reservation about not applying the recognition exemption in such situations, but said he was unable to identify a specific situation for which it would create difficulties in practice. Therefore, he agreed with the recommended approach because it is practical to apply.

Staff analysis

C8. We continue to think that the recognition exemption should not apply in these circumstances for the reasons explained in paragraph 30 of this paper.

Illustrative example for advance lease payments and initial direct costs

Summary of comments

C9. Committee members agreed with our recommendation to provide an example explaining the deferred tax accounting for advance lease payments and initial direct costs.