International Financial Reporting Standard

Deferred Tax related to Assets and Liabilities arising from a Single Transaction

May 2021

BASIS FOR CONCLUSIONS – AMENDMENTS

[IAS 12]

[Related to AASB 2021-5]

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

This Basis for Conclusions accompanies, but is not part of, IAS 12.

Paragraph BC1 is amended with deleted text struck through and new text underlined. Paragraphs BC71–BC95 and related headings are added. For ease of reading, paragraphs BC71–BC95 and the related headings have not been underlined.

Introduction

BC1 When IAS 12 *Income Taxes* was issued by the International Accounting Standards Committee in 1996 to replace the previous IAS 12 *Accounting for Taxes on Income* (issued in July 1979), the Standard was not accompanied by a Basis for Conclusions. This Basis for Conclusions is not comprehensive. It summarises only the considerations of the International Accounting Standards Board~~'s~~ (Board) ~~considerations~~ in developing ~~making the~~ amendments to IAS 12 since ~~contained in *Deferred Tax: Recovery of Underlying Assets* issued in December~~ 2010. Individual Board members gave greater weight to some factors than to others.

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Deferred Tax related to Assets and Liabilities arising from a Single Transaction (2021 amendments)

BC71 In May 2021 the Board issued *Deferred Tax related to Assets and Liabilities arising from a Single Transaction*. The amendments narrowed the scope of the recognition exemption in paragraphs 15 and 24 of IAS 12 (recognition exemption) so that it no longer applies to transactions that, on initial recognition, give rise to equal taxable and deductible temporary differences.

BC72 The amendments were issued in response to a recommendation from the Interpretations Committee. Research conducted by the Interpretations Committee indicated that views differed on whether the recognition exemption applied to transactions, such as leases, that lead to the recognition of an asset and liability. These differing views resulted in entities accounting for deferred tax on such transactions in different ways, reducing comparability between their financial statements.

BC73 For simplicity, paragraphs BC74–BC91 explain the basis for the amendments using leases as an example. The explanation applies equally to other transactions affected by the amendments, such as decommissioning, restoration and similar liabilities (decommissioning obligations) and the corresponding amounts recognised as part of the cost of the related asset.

Background

Temporary differences and the application of the recognition exemption

BC74 Applying IFRS 16 *Leases*, an entity recognises a right-of-use asset (lease asset) and a lease liability at the commencement date of a lease. On initial recognition of the lease asset and lease liability, an entity assesses whether temporary differences arise in determining whether to recognise deferred tax. In making this assessment, an entity determines the tax bases of the lease asset and lease liability by identifying the amounts attributable to them for tax purposes. In some jurisdictions, an entity may receive tax deductions for lease payments when it makes such payments. In such situations, 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.

BC75 An entity applies judgement in determining whether tax deductions are attributable to the lease asset or lease liability, having considered the applicable tax law.

BC76 Applying IAS 12, temporary differences arise on initial recognition only when the entity determines that tax deductions are attributable to the lease liability because:

(a) when tax deductions are attributable 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 will 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. Accordingly, the entity does not recognise deferred tax on initial recognition but does so if and when temporary differences arise after initial recognition.

(b) when tax deductions are attributable to the lease liability, the tax bases of the lease asset and lease liability are nil, reflecting that the entity will receive tax deductions in respect of the lease liability equal to its carrying amount and will receive no tax deductions on recovering the carrying amount of the lease asset. Consequently, temporary differences associated with the lease asset and lease liability arise on initial recognition of the lease.

BC77 Before the amendments were issued, views differed on whether the recognition exemption applied to temporary differences that arise in the situation described in paragraph BC76(b). If an entity concluded that the recognition exemption applied, it recognised no deferred tax in respect of the lease (either on initial recognition or subsequently throughout the lease term).

Purpose of the recognition exemption

BC78 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 the resulting deferred tax liability or asset and adjust the carrying amount of the asset or liability by the same amount. Such adjustments would make the financial statements less transparent and IAS 12, therefore, prohibits the recognition of deferred tax in these circumstances.

BC79 The Board observed that, when temporary differences arise on initial recognition of a lease asset and lease liability, these temporary differences are often equal and offsetting (that is, the taxable and deductible temporary differences are of the same amount). If the recognition exemption were not applied, an entity would generally recognise a deferred tax asset and liability of the same amount for these temporary differences. The recognition of a deferred tax asset and liability of the same amount would not require an adjustment to the carrying amount of the related lease asset or lease liability; nor would it have any effect on profit or loss. Thus, the outcome the recognition exemption was designed to prevent would not occur in such situations. The Board, therefore, concluded that the recognition exemption is not generally needed if on initial recognition a transaction gives rise to equal taxable and deductible temporary differences.

Narrowing the scope of the recognition exemption

BC80 In the light of the observations summarised in paragraph BC79, the Board decided to narrow the scope of the recognition exemption so that it does not apply to transactions that, on initial recognition, give rise to equal taxable and deductible temporary differences.

BC81 The Board considered how this narrower scope of the recognition exemption would apply when an entity does not recognise a deferred tax asset and liability of the same amount for equal taxable and deductible temporary differences. Specifically, an entity could recognise a deferred tax asset and liability of different amounts if it is unable to recognise the deferred tax asset in full (see paragraphs BC82–BC87), or if different tax rates apply to the measurement of each temporary difference (see paragraph BC88).

Inability to recognise deferred tax assets

BC82 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’ (the recoverability requirement). Because of the recoverability requirement, sometimes equal taxable and deductible temporary differences might result in an entity recognising unequal amounts of deferred tax assets and liabilities.

BC83 To address this situation, when it exposed draft amendments for comment, the Board proposed that the recognition exemption continue to apply to the extent that an entity would otherwise recognise unequal amounts of deferred tax assets and liabilities (the capping proposal). Applying the capping proposal, an entity would recognise deferred tax assets and liabilities of the same amount and only to the extent that, applying the recoverability requirement, the entity would recognise a deferred tax asset.

BC84 Feedback on the draft amendments indicated that the capping proposal would be:

(a) inconsistent with the principles in IAS 12 because the Standard generally requires an entity to recognise a deferred tax liability for all taxable temporary differences; and

(b) complex and burdensome to apply.

BC85 In response to this feedback, the Board removed the capping proposal. The Board concluded that:

(a) applying the recognition exemption to a deferred tax liability only because an entity is unable to recognise a corresponding deferred tax asset applying the recoverability requirement would be inconsistent with how the recognition exemption is applied in other situations.

(b) removing the capping proposal would significantly reduce the complexity of applying the amendments while still achieving their objective (see BC92(a)). In particular, by removing the capping proposal, the Board would:

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

(ii) simplify the accounting when, on initial recognition, deferred tax assets are not recognised in full. In such cases, had the capping proposal been retained in the amendments, entities would have been required to track separately the portions of temporary differences to which the recognition exemption was applied.

BC86 Removing the capping proposal might result in an entity recognising unequal amounts of deferred tax assets and liabilities on initial recognition of a transaction. In such cases, an entity would recognise any difference in profit or loss (see paragraph 22(b) of IAS 12). For example, an entity would recognise an income tax loss if, on initial recognition, it recognises a deferred tax liability but is unable to recognise an equal and offsetting deferred tax asset. The Board concluded that this accounting appropriately reflects the entity's expectation that it will be unable to benefit fully from the tax deductions available when it settles the liability, but that it is nonetheless required to make future tax payments as it recovers the asset. As explained in paragraph BC85(a), applying the recognition exemption to the deferred tax liability only because an entity is unable to recognise a corresponding deferred tax asset would be inconsistent with how the recognition exemption is applied in other situations.

BC87 Further, the Board expects that unequal amounts of deferred tax assets and liabilities would arise on initial recognition only infrequently, because an entity might often meet the recoverability requirement through the future reversal of taxable temporary differences arising from the same transaction.

Different tax rates apply

BC88 An entity might recognise a deferred tax asset and liability of different amounts for equal taxable and deductible temporary differences if different tax rates apply to the measurement of the deferred tax asset and liability. As noted in paragraph BC86, an entity would recognise any difference in profit or loss. The Board concluded that the expected benefits of applying the recognition exemption in these situations would not outweigh the costs because:

(a) applying the recognition exemption in these situations would be complex because the recognition exemption would apply to only a small portion of the resulting deferred tax; and

(b) these situations are expected to arise only in a limited number of jurisdictions and the net effect of applying different tax rates will often be immaterial.

Other considerations

Attribution of tax deductions to the lease asset or lease liability

BC89 Some respondents to the draft amendments suggested that the Board provide application guidance to help entities assess whether tax deductions are attributable to the lease asset or lease liability (see paragraph BC74). The Board decided not to provide such application guidance because the expected benefits of doing so would not outweigh the costs. The Board concluded that providing such guidance:

(a) was unnecessary to achieve the objective of the amendments—the amendments will result in entities recognising deferred tax for temporary differences that arise on leases (either on initial recognition or subsequently) regardless of whether tax deductions are attributable to the lease asset or lease liability; and

(b) could cause unintended consequences—any such guidance could affect how entities, in other situations, consider the applicable tax laws in determining the tax base of assets and liabilities.

Advance lease payments and initial direct costs

BC90 Applying IFRS 16, an entity initially measures a lease liability at the present value of the lease payments not paid at the commencement date. An entity's initial measurement of a lease asset includes the initial measurement of the lease liability as well as advance lease payments and initial direct costs.

BC91 The recognition of the lease liability and the related component of the lease asset's cost may give rise to equal taxable and deductible temporary differences as explained in paragraph BC79. The amendments apply to any such equal taxable and deductible temporary differences that arise. In addition, making advance lease payments or paying initial direct costs could result in additional taxable temporary differences associated with the lease asset, to which an entity would apply the applicable requirements in IAS 12. In response to requests to do so, the Board included an example illustrating the accounting for deferred tax on advance lease payments and initial direct costs.

Effect analysis

BC92 The Board concluded that the expected benefits of the amendments outweigh the costs because:

(a) the amendments will reduce diversity in the reporting of transactions such as leases and decommissioning obligations and align the accounting for deferred tax on such transactions with the general principle in IAS 12 of recognising deferred tax for temporary differences; and

(b) concerns about the costs of applying the draft amendments related mainly to the application of the capping proposal (see paragraph BC84(b)). The Board's decision to remove the capping proposal addressed most of those concerns.

Transition

BC93 The Board decided not to require retrospective application of the amendments in accordance with IAS 8. Instead, it decided to require entities to apply the amendments for the first time by recognising deferred tax for all temporary differences related to leases and decommissioning obligations at the beginning of the earliest comparative period presented. It concluded that these requirements appropriately balance expected benefits and costs. Retrospective application would require entities to retrospectively assess whether each lease and decommissioning obligation gave rise to equal taxable and deductible temporary differences on initial recognition, which could have occurred a long time ago. The Board concluded that its transition approach would, therefore, make the amendments easier and less costly to apply than a full retrospective approach, while still achieving their objective. Such an approach also prevents any uncertainty about how the amendments interact with the transition requirements in IFRS 16.

BC94 The Board also required entities to apply the amendments prospectively to transactions other than leases and decommissioning obligations (that is, to such transactions that occur on or after the beginning of the earliest comparative period presented). Were the amendments to be applied retrospectively, determining whether such transactions are in the scope of the amendments and then reconsidering the accounting for those transactions could be costly and complex. The Board concluded that the costs of requiring entities to apply the amendments retrospectively for those other transactions would outweigh the benefits of doing so.

BC95 For reasons similar to those explained in paragraph BC93, the Board required first-time adopters to recognise deferred tax for all temporary differences associated with leases and decommissioning obligations existing at the date of transition to IFRSs.