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IFRS in Focus

IASB issues amendments to IAS 12 to clarify the recognition of deferred tax assets for unrealised losses related to debt instruments measured at fair value

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The Bottom Line

- The amendments clarify that unrealised losses on debt instruments measured at fair value in the financial statements but at cost for tax purposes can give rise to deductible temporary differences.
- The amendments also clarify that:
  - the carrying amount of an asset does not limit the estimation of probable future taxable profits; and that
  - when comparing deductible temporary differences with future taxable profits, the future taxable profits excludes tax deductions resulting from the reversal of those deductible temporary differences.
- The amendments are to be applied retrospectively and are effective from 1 January 2017 with earlier application permitted.

This edition of IFRS in Focus outlines the recent amendments to IAS 12 *Income Taxes* issued by the International Accounting Standards Board (IASB).

Why have these amendments been issued?

The IFRS Interpretation Committee received a request to clarify the application of IAS 12 for the recognition of a deferred tax in the following circumstances:

- an entity holds a debt instrument classified as available-for-sale and, therefore, measured at fair value but whose tax base is cost;
- the entity estimates that it is probable that the issuer of the debt instrument will make all the contractual payments but changes in market interest rates have caused the fair value of the debt instrument to be below its cost;
- tax law does not allow a loss to be deducted until it is realised for tax purposes;
- the entity has the ability and intention to hold the debt instrument until the unrealised losses reverses (which may be at its maturity);
- tax law prescribes that capital losses can only be offset against capital gains, whilst ordinary losses can be offset against both capital gains and ordinary income; and
- the entity has insufficient taxable temporary differences and no other probable taxable profits against which the entity can utilise deductible temporary differences.

For more information please see the following websites:

www.iasplus.com

www.deloitte.com

The objective of the amendments is to explain the application of the existing principles in IAS 12 to the situation presented.

What are the amendments to IAS 12?

The amendments clarify that unrealised losses resulting from the circumstances described above give rise to a deductible tax difference regardless of whether the holder expects to recover the carrying amount by holding the debt instrument until maturity or by selling the debt instrument.

Observation

The Interpretations Committee concluded that the balance sheet liability method applied by IAS 12, which focuses on temporary differences, does not require an entity to assume that an asset is recovered only for its carrying amount in estimating probable future taxable profits.

The balance sheet method focuses on the difference between the carrying amount of an asset or a liability in the statement of financial position and its tax base at the balance sheet date. By doing so, it determines and limits the tax effects that an entity accounts for. It does not, however, indicate the conditions that will prevail when the temporary differences reverse and what tax consequences these reversals will have.

In circumstances in which tax law restricts the utilisation of tax losses such that an entity can only deduct the tax losses against income of a specified type, an entity would assess a deferred tax asset in combination with other deferred tax assets of the same type.

The amendments clarify that when estimating taxable profit of future periods, an entity can assume that an asset will be recovered for more than its carrying amount if that recovery is probable and the asset is not impaired. All relevant facts and circumstances should be assessed when making this assessment.

The amendments include an illustrative example to IAS 12 to illustrate the utilisation of deductible temporary differences for different sources of taxable profits (future reversal of existing taxable temporary differences, future taxable profit and tax planning opportunities) that are available but insufficient to offset existing deductible temporary differences.

Observation

The Board intends to explain in the illustrative example that entities need to have sufficient evidence to support the assessment that the amount by which an asset will be recovered is higher than its carrying amount. In the example added to IAS 12, the contractual nature of future cash flows, and assessment of the likelihood that those contractual cash flows will be received are considered sufficient to support that conclusion.

The amendments make clear that, in evaluating whether sufficient future taxable profits are available, an entity should compare the deductible temporary differences with the future taxable profits excluding tax deductions resulting from the reversal of those deductible temporary differences.

Observation

The references in the amendment to "tax deductions from the reversal of those deductible temporary differences" may initially appear confusing as in the circumstances described movements in the fair value of the asset have no immediate tax impact and so increases in fair value of the asset to maturity have no tax impact. However, for tax purposes when the debt is recovered (at an amount equal to original cost), the cash received from the asset is taxable income with an equal tax deduction for the original cost, giving no taxable profit. The words of the amendment are not referring to a separate tax deduction equal to the temporary difference; rather it is part of the total tax deduction for the debt in the calculation of taxable profit.

What the amendment and the illustrative example that accompanies it are, in fact, making clear is that the cumulative difference between accounting and taxable profit forecast on that asset, that results in the reversal of the deductible temporary difference is treated as a source of 'taxable profit' for the purposes of assessing whether a deferred tax asset is recoverable.

Effective date and transition requirements

The amendments are effective from 1 January 2017 with earlier application permitted.

An entity is required to apply the amendments retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors.* However, in applying the amendments in the first opening statement of financial position, an entity is not required to make transfers between retained earnings and other components of equity to restate cumulative amounts previously recognised in profit or loss, other comprehensive income or directly in equity. If an entity does not make such transfers, it should disclose that fact. The amendments do not include any specific transition relief for first time adopters.

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