

Draft Comment Letter

Comments should be submitted by 28 November 2014 to
commentletters@efrag.org

12 September 2014

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir/Madam,

Re: Recognition of Deferred Tax Assets for Unrealised Losses (Proposed Amendments to IAS 12)

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft ED/2014/3 *Recognition of Deferred Tax Assets for Unrealised Losses* (Proposed Amendments to IAS 12), issued by the IASB on 20 August 2014 (the 'ED').

This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRS in the European Union and European Economic Area.

Our detailed comments and responses to the questions in the ED are set out in the Appendix. To summarise, we agree with most of the proposals in the ED. There is some debate as to the extent of clarification that the IASB should make, as some consider the extent of the proposed clarifications seem superfluous while others consider that the requests put to the IFRS Interpretations Committee and the analysis done by the Interpretations Committee and the IASB shows that these are useful. EFRAG is seeking views of its constituents as outlined in the appendix to this letter.

In summary, EFRAG has some concerns or wording suggestions on the following issues:

- EFRAG recommends that the example that illustrates paragraph 26(d) also explains that it is irrelevant, for the purpose of assessing whether a deductible temporary difference arises, whether the debt instrument is measured at FVPL or at FVOCI;
- EFRAG is asking to constituents whether they agree with the IASB's intention to add paragraph 29A to the body of the Standard to clarify that, when an entity estimates taxable profit in future periods for assessing the utilisation of deductible temporary differences, it can assume that an asset can be recovered for more than its carrying amount;
- EFRAG believes that paragraph 29(a)(i) is difficult to read and recommends that an illustrative example is introduced into the body of the Standard for clarification. In addition, we believe that it should be further explained in the Basis for

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Conclusions that the utilisation of deductible temporary differences is not assessed against future taxable profit for a period upon which income taxes are payable; and

- In relation to the proposal to add paragraph 27A to IAS 12 to clarify how entities have to group deductible temporary differences when assessing their utilisation, EFRAG believes that the Basis for Conclusions should explain the clarification for those who believe that a separate assessment should be made for the particular case of debt instruments illustrated in paragraph 26(d).

If you would like to discuss our comments further, please do not hesitate to contact David Martin Garcia or me.

Yours faithfully,

Françoise Flores
EFRAG Chairman

APPENDIX

Notes to constituents

- 1 *The proposed amendments to IAS 12 are in response to a request to the IFRS Interpretations Committee to clarify the recognition of a deferred tax asset that is related to a debt instrument measured at fair value in circumstances in which:*
 - (a) *changes in the market interest rate decrease the fair value of the debt instrument below cost;*
 - (b) *it is probable that the debt instrument's holder will receive all the contractual cash flows if it holds the debt instrument until maturity;*
 - (c) *the debt instrument's holder has the ability and intention to hold the debt instrument until the decrease in its fair value reverses (which may be at its maturity);*
 - (d) *the tax base of the debt instrument remains at cost until the debt instrument is sold or until maturity. The tax base of the debt instrument is not reduced by an impairment loss, because the criteria for recognising an impairment loss for tax purposes are not met; and*
 - (e) *the probable future taxable profits of the debt instrument's holder are insufficient for the utilisation of all of its deductible temporary differences.*

Question 1—Existence of a deductible temporary difference

The IASB proposes to confirm that decreases in the carrying amount of a fixed-rate debt instrument for which the principal is paid on maturity give rise to a deductible temporary difference if this debt instrument is measured at fair value and if its tax base remains at cost. This applies irrespective of whether the debt instrument's holder expects to recover the carrying amount of the debt instrument by sale or by use, ie by holding it to maturity, or whether it is probable that the issuer will pay all the contractual cash flows.

Do you agree with the proposed amendment? Why or why not? If not, what alternative do you propose?

Notes to constituents

- 2 *Paragraphs 20 and 26(d) of IAS 12 specify that a difference between the carrying amount of an asset measured at fair value and its higher tax base gives rise to a deductible temporary difference. The tax base of the debt instrument is deductible for tax purposes either on sale or on maturity.*
- 3 *The IASB proposes to add an example after paragraph 26 of IAS 12 to illustrate the identification of a deductible temporary difference in the case of a fixed-rate debt instrument measured at fair value for which the principal is paid on maturity.*
- 4 *The example proposed illustrating paragraph 26(d) of IAS 12 states that decreases in the carrying amount of a fixed-rate debt instrument for which the principal is paid on maturity give rise to a deductible temporary difference if this debt instrument is measured at fair value and if its tax base remains at cost. This applies irrespective of whether the debt instrument's holder expects to recover the carrying amount of the debt instrument by sale or by use.*

- 5 *The proposed example states that the economic benefit embodied in the related deferred tax asset results from the ability of the holder of the debt instrument to achieve future taxable gains in the amount of the deductible temporary difference without paying taxes on those gains.*

EFRAG's response

EFRAG agrees with the proposed amendments. However, EFRAG recommends that the example that illustrates paragraph 26(d) also explains that it is irrelevant, for the purpose of assessing whether a deductible temporary difference arises, whether the debt instrument is measured at FVPL or at FVOCI.

- 6 EFRAG welcomes the proposal to clarify that the decrease below cost in the carrying amount of a debt instrument measured at fair value for which the principal is paid at maturity give rise to a deductible temporary difference.
- 7 EFRAG agrees that, while in a situation as the one described above, it is more intuitive that a deductible temporary difference arises where the entity expects to recover the carrying amount of the asset by sale, it is not self-evident in situations where the entity expects to recover the carrying amount of the asset just by holding the debt instrument until maturity. In the latter case, some have difficulties in identifying the tax benefits embodied in the resulting deferred tax asset. As explained in the Basis for Conclusions, the economic benefit embodied in the related deferred tax asset results from the fact that, at maturity, the holder of the debt instrument can achieve taxable gains without paying taxes on those gains because it has tax deductions of the same amount.
- 8 Although EFRAG believes that the conclusion should be the same regardless of whether the debt instrument is measured at FVPL or at FVOCI, EFRAG is aware that part of the confusion existing on the issue refers to the fact that some believe that deferred tax assets on unrealised losses are not realised for tax purposes unless they are accounted for in profit or loss (for example when objective evidence exists that the asset is impaired)
- 9 Therefore, EFRAG recommends that the example that illustrates paragraph 26(d) also explains that it is irrelevant, for the purpose of assessing whether a deductible temporary difference arises, whether the debt instrument is measured at FVPL or at FVOCI. This conclusion can be deduced however, from the illustrative example included as part of the proposed amendments to the non-mandatory guidance.

Question 2—Recovering an asset for more than its carrying amount

The IASB proposes to clarify the extent to which an entity's estimate of future taxable profit (paragraph 29) includes amounts from recovering assets for more than their carrying amounts.

Do you agree with the proposed amendment? Why or why not? If not, what alternative do you propose?

Notes to constituents

- 10 *With some exceptions, deferred tax assets arising from deductible temporary differences are recognised to the extent that sufficient future taxable profits will be available against which the deductible temporary differences are utilised (see paragraph 24 of IAS 12).*

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- 11 *Paragraphs 28–29 of IAS 12 identify three sources of taxable profits against which an entity can utilise deductible temporary differences. They are:*
- (a) *future reversal of existing taxable temporary differences;*
 - (b) *taxable profit in future periods; and*
 - (c) *tax planning opportunities.*
- 12 *Deferred tax assets arising from deductible temporary differences are recognised only to the extent that it is probable that at least one of these sources of taxable profits is available.*
- 13 *The assessment on whether an entity can recover an asset for more than its carrying amount when estimating future taxable profits is relevant when taxable profit from other sources (i.e. paragraph 11 (a) and (c) above) is insufficient for the utilisation of the deductible temporary differences related to debt instruments measured at fair value. In effect, an entity might only be able to recognise deferred tax assets for its deductible temporary differences if it is probable that it will collect the entire cash flows from the debt instrument and therefore recover it for more than its carrying amount.*
- 14 *The IASB proposes to add paragraph 29A to IAS 12 to clarify the extent to which an entity's estimate of future taxable profit (paragraph 29) includes amounts from recovering assets for more than their carrying amounts.*

Question to constituents

- 15 EFRAG is aware that there are significant different views on this issue and is seeking the views of constituents. Which of the two alternatives described below do you support? Please explain.

EFRAG's response

Alternative 1:

EFRAG agrees with the IASB's proposed amendment as it will help to reduce diversity in practice on how entities estimate future taxable profits against which deductible temporary differences are assessed for utilisation. However, EFRAG recommends that paragraph 29A should explain that recovery of an asset for more than its carrying amount is unlikely to be probable if, for example, the asset is measured at fair value rather than cost.

- 16 EFRAG agrees with the IASB's proposed amendment as it will reduce diversity in practice on how entities estimate future taxable profits against which deductible temporary differences are assessed for utilisation.
- 17 EFRAG agrees that the carrying amount of an asset does not limit the estimation of probable future taxable profit. Indeed, if the assessment of the recoverability of deferred tax assets were based on the assumption that all assets are recovered for their carrying amount, entities could not estimate any future profit at all and, therefore, deferred tax assets could never be recognised. This is also well illustrated by the example of the manufacturing entity included in paragraph BC13 of the Basis for Conclusions that accompany the proposed amendments.
- 18 However, EFRAG believes that paragraph 29A should mention that recovery of an asset for more than its carrying amount is unlikely to be probable if, for example, the asset is measured at fair value rather than cost (as it is stated in paragraph

BC15 of the Basis for Conclusions that accompany the proposed amendments). Otherwise, entities could predict that, for example, the fair value of an investment property (measured using the fair value model under IAS 40 *Investment Property*) will increase in the future above its carrying amount when estimating its future taxable profits. EFRAG believes that this it is not the IASB's intention and therefore, such a clarification should not be made in the Basis for Conclusions but in the mandatory part of the Standard in order to avoid possible unintended consequences.

Alternative 2:

EFRAG disagrees with the IASB's proposed amendment. In our view, the proposed amendment, if any, should be restricted to situations where an entity has a contractual right or supportive evidence that the asset will be recovered for more than its carrying amount.

- 19 EFRAG disagrees with the IASB's proposed amendment. First, EFRAG believes that the proposed amendment could appear self-evident. In effect, if the assessment of the recoverability of deferred tax assets were based on the assumption that all assets are recovered for their carrying amount, entities could not estimate any future profit at all and, therefore, deferred tax assets could never be recognised.
- 20 Second, EFRAG believes that the guidance provided in paragraph 29A and in the Basis for Conclusions of the proposed amendments does not provide a sufficient basis to assess the circumstances under which an entity may assume it will recover an asset for more than its carrying amount. In EFRAG's view, that clarification, if any, should be restricted to situations where an entity has a contractual right or supportive evidence that the asset will be recovered for more than its carrying amount. The example of the debt instrument proposed to illustrate paragraph 26(d) could be referred as an example of these situations.
- 21 In effect, in the proposed example illustrating paragraph 26(d), it seems reasonable to consider that the debt instrument may be recovered at maturity for an amount higher than its carrying amount.
- 22 However, EFRAG believes that, out of that limited example or other very specific situations, the guidance proposed by the IASB is not clear enough to clarify the assessments that have to be made by entities when estimating future taxable profit against which deductible temporary differences are assessed for utilisation. Instead, the proposed paragraph 29A requires consideration of all relevant facts and circumstances. For example, difficulties could arise on the assessment of the following:
 - (a) Under which circumstances an entity may consider future taxable profits/losses resulting from the estimated sale of a fixed asset (or an equity instrument for example) in future periods; i.e., whether for example a binding contract for the sale of an asset is needed for the basis of such assumptions;
 - (b) Whether an entity may consider in its estimation of future taxable profits future losses resulting from a restructuring plan or not (i.e., whether it should be aligned with the requirements in IAS 36 *Impairment of Assets* or not);
 - (c) Whether an entity using the fair value model under IAS 40 *Investment Property* could predict that, for example, the fair value of an investment property will increase in the future above its carrying amount when estimating its future taxable profits.

- 23 In EFRAG's view, the IASB has not provided enough evidence in this regard to conclude on the proposed amendment in paragraph 29A. EFRAG believes that the inclusion of such a paragraph, without limiting the conclusion to situations where an entity has a contractual right or supportive evidence (as it happens in the particular case of the example proposed to illustrate paragraph 26(d)), could generate unintended consequences.

Question 3—Probable future taxable profit against which deductible temporary differences are assessed for utilisation

The IASB proposes to clarify that an entity's estimate of future taxable profit (paragraph 29) excludes tax deductions resulting from the reversal of deductible temporary differences.

Do you agree with the proposed amendment? Why or why not? If not, what alternative do you propose?

Notes to constituents

- 24 *Taxable profit (tax loss) is the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable) (see paragraph 5 of IAS 12).*
- 25 *The utilisation of deductible temporary differences is not, however, assessed against probable future taxable profit for a period upon which income taxes are payable. The IASB proposes to clarify in paragraph 29(a) that the utilisation of deductible temporary differences is assessed against probable future taxable profit that excludes tax deductions resulting from the reversal of deductible temporary differences.*

EFRAG's response

EFRAG welcomes the proposal as we are aware that diversity in practice exists on how entities estimate future taxable profits against which deductible temporary differences are assessed for utilisation. However, EFRAG believes that paragraph 29(a)(i) is difficult to read and recommends that an illustrative example is introduced into the body of the Standard for clarification. In addition, we believe that it should be further explained in the Basis for Conclusions that the utilisation of deductible temporary differences is not assessed against future taxable profit for a period upon which income taxes are payable.

- 26 EFRAG welcomes the proposal as we are aware that diversity in practice exists on how entities estimate future taxable profits against which deductible temporary differences are assessed for utilisation.
- 27 EFRAG is aware that part of the confusion on the recognition of deferred tax assets resides on how entities interpret future taxable profit against which deductible temporary differences are assessed for utilisation (under paragraph 29 of IAS 12). In effect, some believe that probable taxable profits calculated for "assessment purposes" is determined excluding any deduction or reversal of deductible temporary differences and therefore, they argue that taxable profit used for "assessment purposes" is not the same as "actual" taxable profit on which income taxes are payable (as defined in paragraph 5 of IAS 12). Others, however, believe that there is only one definition of taxable profit under IAS 12 and it is set out in paragraph 5 of the Standard. In their view, that definition is also used when

determining probable taxable profits when assessing recognition of a deferred tax asset.

- 28 Because of this confusion, EFRAG believes that the wording of paragraph 9(a)(i) is difficult to read. Therefore, EFRAG believes that it would be helpful to introduce a short illustrative example in the body of the Standard to illustrate this issue. EFRAG proposes the following illustrative example:

29 Entity A bought a debt instrument with a nominal value of CU1,000. Its fair value on 31 December 2013 is CU800. A determines that there is a deductible temporary difference of CU200. A expects to hold the instrument until its maturity on 31 December 2014 and collect the CU1,000, reversing therefore the deductible temporary difference. In addition, A has a taxable temporary difference of CU50 that will also reverse in 31 December 2014. A expects that in 2015 its future taxable profit upon which income taxes are payable will be a loss of CU50. A's income tax rate is 30%.

- 30 **Step 1:** utilisation of deductible temporary differences because of the reversal of taxable temporary differences

| | |
|--|------|
| Deductible temporary difference | 200 |
| Reversal of taxable temporary difference | (50) |
| Remaining amount to be tested for utilisation (step 2) | 150 |

- 31 In step 1, entity A can recognise at least a deferred tax asset in relation to a deductible temporary difference of 50.

- 32 **Step 2:** utilisation of deductible temporary differences because of future taxable profit

| | |
|--|------|
| Expected tax loss (upon which income taxes are payable) | (50) |
| Minus reversal of taxable temporary differences (utilised in step 1) | (50) |
| Plus reversal of deductible temporary differences | 200 |
| Taxable profit for assessing the utilisation of deductible temporary differences | 100 |

- 33 In step 2, entity A can recognise a deferred tax asset in relation to a deductible temporary difference of 100. Therefore, entity A would recognise a deferred tax asset of 45 $((50+100) \times 30\%)$.

- 34 In addition, although it is implicit in paragraph 29(a)(i), we believe that the Basis for Conclusions should explain that the utilisation of deductible temporary differences is not assessed against probable future taxable profit for a period upon which income taxes are payable. We note that it is expressed however, in paragraph IE38 of the illustrative example that accompanies the mandatory guidance of the Standard.

Question 4—Combined versus separate assessment

The IASB proposes to clarify that an entity assesses whether to recognise the tax effect of a deductible temporary difference as a deferred tax asset in combination with other deferred tax assets. If tax law restricts the utilisation of tax losses so that an entity can only deduct tax losses against income of a specified type or specified types (eg if it can deduct capital losses only against capital gains), the entity must still assess a deferred tax asset in combination with other deferred tax assets, but only with deferred tax assets of the appropriate type.

Do you agree with the proposed amendment? Why or why not? If not, what alternative do you propose?

Notes to constituents

- 35 *The IASB proposes to add paragraph 27A to IAS 12 to clarify that if tax law offsets a deduction against taxable income on an entity basis, without segregating deductions from different sources, an entity carries out a combined assessment of all its deductible temporary differences relating to the same taxation authority and the same taxable entity. However, if tax law offsets specific types of loss only against a particular type or particular types of income (for example, if it limits the offset of capital losses to capital gains), an entity assesses a deductible temporary difference in combination with other deductible temporary differences of that type(s), but separately from other deductible temporary differences. Only segregating deductible temporary differences in accordance with tax law and assessing them on such a combined basis determines whether taxable profits are sufficient to utilise deductible temporary differences.*
- 36 *This question is relevant, for example, when tax law distinguishes capital gains and losses from other taxable gains and losses and capital losses can only be offset against capital gains.*

EFRAG's response

EFRAG welcomes the proposed amendment to paragraph 27A of IAS 12 as they add clarity to IAS 12 on how entities have to group deductible temporary differences when assessing their utilisation. However, EFRAG believes that the Basis for Conclusions should explain this clarification for those who believe that, for the particular case of debt instruments illustrated in paragraph 26(d), a separate assessment should be made.

- 37 EFRAG agrees with the proposed amendments in paragraph 27A of IAS 12 as they add clarity to IAS 12 on how entities have to group deductible temporary differences when assessing their utilisation.
- 38 While IAS 12 requires taxes in the same entity and for the same tax jurisdiction to be presented net (under certain conditions), there is no explicit requirement within IAS 12 to separate capital and ordinary items, despite the fact that there are tax laws in some jurisdictions which limit the ability of a company to offset capital losses against ordinary income. This may be a reason why different companies have interpreted the requirements of IAS 12 differently. That is, some companies evaluate temporary differences for capital items separate from ordinary items. Other companies combine the capital and ordinary items when assessing whether or not to recognise a deferred tax asset. Depending on which approach is adopted, it impacts the net deferred tax assets and, consequently, the recognition criteria of whether a deferred tax asset can be recognised or not.
- 39 EFRAG has learnt from the due process followed by the IASB that diversity in practice arises in the particular case of deductible temporary differences related to

unrealised losses on debt instruments measured at fair value. In effect, some assess the utilisation of deductible temporary differences related to unrealised losses on debt instruments separately from other deferred tax assets. This is because they believe that deductible temporary differences relating to unrealised losses are unique and that they can be recognised without a future tax deduction. In other words, these temporary differences are expected to reverse through the passage of time without affecting future taxable profits and, therefore, supporters of this view do not require to these particular deductible temporary differences a reduction in future tax payments as a requisite for the recognition of the corresponding deferred tax asset.

- 40 However, EFRAG notes that the arguments of those who support a separate assessment in the particular case of debt instruments illustrated in paragraph 26(d) (as described in paragraph 39 above) are not provided in the Basis for Conclusions. EFRAG would welcome a reference to them in the Basis for Conclusions. In our view, the reference to paragraph 27 of IAS 12 in paragraph BC19 and the clarification provided in paragraph BC20 of the proposed amendments are enough for rebutting the view that separate assessment is not appropriate in the particular example of paragraph 26(d).

Question 5—Transition

The IASB proposes to require limited retrospective application of the proposed amendments for entities already applying IFRS. This is so that restatements of the opening retained earnings or other components of equity of the earliest comparative period presented should be allowed but not be required. Full retrospective application would be required for first-time adopters of IFRS.

Do you agree with the proposed amendment? Why or why not? If not, what alternative do you propose?

Notes to constituents

- 41 *The IASB proposes a limited mandatory retrospective application for entities already applying IFRS. Restatements of the opening retained earnings or other components of equity of the earliest comparative period presented are allowed but not required.*
- 42 *The IASB proposes no transition relief for first-time adopters. This is consistent with the fact that IFRS 1 First-time Adoption of International Financial Reporting Standards does not include an exception to, or exemption from, the retrospective application of the requirements in IAS 12.*

EFRAG's response

EFRAG agrees with the proposed transition requirements.

- 43 EFRAG agrees with the transition requirements proposed in the ED both for entities already applying IFRS and for first-time adopters of IFRS.