ICAEW
REPRESENTATION 118/19

DEFERRED TAX RELATED TO ASSETS AND LIABILITIES ARISING FROM A SINGLE TRANSACTION

Issued 14 November 2019

ICAEW welcomes the opportunity to comment on the ED/2019/5 *Deferred Tax related to Assets and Liabilities arising from a Single Transaction* published by IASB in July 2019, a copy of which is available from this link.

IASB supports attempts to ensure that useful and comparable information is provided on temporary differences arising on the initial recognition of assets and liabilities relating to leases and decommissioning obligations. However, we have some concerns about how the proposals interact with the general principles of IFRS 16 *Leases* and IAS 12 *Income Taxes* and with the introduction of further complexity in relation to the accounting for leases, decommissioning obligations and deferred tax.

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KEY POINTS

FURTHER THOUGHT NEEDED

1. ICAEW believes that deferred tax provides useful information to users of the financial statements. We therefore support IASB attempts to ensure that useful and comparable information is provided on temporary differences arising on the initial recognition of assets and liabilities relating to leases and decommissioning obligations.
2. We broadly agree that the proposal to narrow the scope of the initial recognition exemption (IRE) in IAS 12 *Income Taxes* has the potential to improve the information provided to users of financial statements and to improve comparability between companies. The objective of the IRE is to avoid a profit and loss impact on initial recognition of an asset or liability that arises solely from deferred tax. We understand that the proposed amendments aim to maintain that objective and we support that intention.
3. However, we have some concerns about how the proposals interact with the general principles of IFRS 16 *Leases* and IAS 12. We also note that the proposals would introduce further complexity in relation to the accounting for leases, decommissioning obligations and deferred tax. Careful consideration should be given as to whether the expected benefits to users of the proposed amendments would outweigh the potential costs to preparers of applying the requirements, both initially and over time.
4. Should the IASB decide to proceed with the proposed amendments, we also believe that further guidance would be necessary in a number of areas. These matters are discussed below.

ANSWERS TO SPECIFIC QUESTIONS

Question 1

Do you agree with the Board's proposal to amend IAS 12 in the manner described in the Exposure Draft? If not, why not, and what do you recommend instead?

5. As noted, we broadly agree that the proposal to narrow the scope of the initial recognition exemption (IRE) in IAS 12 *Income Taxes* has the potential to improve the information provided to users of financial statements and to improve comparability between companies. However, we have a number of concerns as discussed below:

Inconsistency in terminology

6. There is some inconsistency in the drafting of the proposed amendments which we believe may result in confusion. Proposed paragraph 22(c) refers to transactions that 'do not result in the recognition of equal amounts of deferred tax assets and liabilities' ie, the focus is on the deferred tax balances being equal. However, proposed paragraph 22A refers to transactions that give rise to 'equal amounts of taxable and deductible temporary differences' ie, the focus is on the temporary differences being equal.
7. We believe it is important for the IASB to make clear whether the amounts that must be equal for the proposed amendment to apply are: the temporary differences arising on initial recognition of a lease or decommissioning obligation; or the resulting deferred tax asset and liability. If it is the former then the exception would appear to work as in quantitative terms the temporary differences will equal each other. If it is the latter, then this may not be the case as once the relevant tax rates are applied to the temporary differences, the deferred tax asset and deferred tax liability may end up being different amounts.

8. We also note that proposed paragraph 22A(b) goes on to refer to how the 'deferred tax liability shall not exceed the amount of the deferred tax asset recognised' which brings the focus back to the deferred tax balances being equal. We understand that paragraph 22A(b) is describing how an entity might achieve an equal deferred tax asset and deferred tax liability within the context of paragraph 22(c). If this is the case it might be helpful if the amendments are redrafted to make this clear.

Advance lease payments and payment of indirect costs

9. BC18 explains how the proposed amendments would not apply to any advance lease payments or the payment of initial direct costs - these would continue to apply the existing requirements of IAS 12. In our view, the division of the leased asset into different components is not consistent with the principle in IFRS 16 that considers the 'right of use asset' as one unit of account. It also means that entities would need to keep track of the separate components of the leased asset for the purpose of measuring deferred tax over time, which would introduce further complexity and additional work for entities. As noted above, this additional time/effort to preparers, and the associated cost, needs to be balanced against the expected benefit to users from the resulting information.
10. In our view, a better approach might be to require entities to follow a 'liability first' approach. To demonstrate, we have set out below an example of the suggested order in which a preparer would calculate the deferred tax on initial recognition of a lease or decommissioning obligation if following a 'liability first' approach:
    - The lease liability or decommissioning liability is recognised in accordance with IFRS 16 or IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, respectively.
    - The lease liability or decommissioning obligation drives the calculation of the deferred tax asset (subject to the assessment of recoverability).
    - The lease liability or decommissioning obligation also drives the calculation of the right of use lease asset (before taking into consideration any initial direct costs) or decommissioning component of property, plant and equipment (PPE).
    - In turn, the right of use asset or the decommissioning component of PPE drives the calculation of the deferred tax liability (subject to any limitation from the recognition of the deferred tax asset).
    - The right of use asset would then be adjusted for any initial direct costs.
11. While this would not affect the end result, and still involves a degree of complexity, it might be a more intuitive way of approaching the matter ie, rather than splitting the right of use asset into component parts which, as noted above, is contrary to the principles of IFRS 16.

Limitation on recognising deferred tax liability to amount of deferred tax asset

12. Under the proposals, if the deferred tax assets recognised are less than the deferred tax liability (for example, because all/part of it isn't considered recoverable) then the amount of the deferred tax liability recognised would be adjusted accordingly. In our view, this is at odds with the basic principle in IAS 12 that deferred tax liabilities are always recognised. It also creates a further exception, in addition to the exception outlined in the exposure draft, which arguably creates further unhelpful complexity in IAS 12.
13. There is also very limited guidance in the exposure draft around what happens on subsequent recognition. In our view, this leaves some unanswered questions and may, without further guidance, result in continued diversity in practice.
14. To demonstrate, BC26 provides some guidance around the reassessment of unrecognised deferred tax assets. It states that if an entity considers that it did not recognise deferred tax

assets (relating to leases or decommissioning obligations) because of the recognition exemption, then IAS 12 (paragraph 22c) would preclude their subsequent recognition. However, if an entity considers that it did not recognise deferred tax assets because of the recoverability judgement, it would be required to subsequently reassess unrecognised deferred tax assets (in accordance with paragraph 37 of IAS 12).

15. While the guidance in BC26 is helpful, in our view, it only partially deals with the matters arising on subsequent measurement. For example, if deferred tax assets were to be increased following a reassessment, should an entity:

    - Adjust the deferred tax liability by an equal and opposite amount to the deferred tax asset increase?
    - Adjust the deferred tax liability by an equal and opposite amount to the deferred tax asset increase, but with an upper limit (ceiling) based on the actual Taxable Temporary Difference (TTD) on the leased asset?
    - Continue to apply the original limitation (ie, make no corresponding adjustment to the deferred tax liability)?

16. Further questions arise when the deferred tax assets are not increased in subsequent periods, but the reversal of the deferred tax liability is faster than the reversal of the deferred tax assets. In this situation, should an entity:

    - Recognise an additional deferred tax liability up to the amount of the deferred tax assets recognised, but with an upper limit (ceiling) based on the actual TTD on the lease asset?
    - Make no additional adjustment to the deferred tax liability beyond the reversal of the TTD originally recognised?

17. The above scenarios are just some examples of the questions we have identified around subsequent recognition. There may be other combinations of adjustments which could raise similar questions. In our view, further explicit guidance or examples would be needed to avoid diversity in practice arising. It may be that entities need to track unrecognised deferred tax assets and deferred tax liabilities, depending on the subsequent measurement requirements.

Application of judgement

18. The Basis of Conclusions outlines how the proposed amendments to IAS 12 would apply on initial recognition of a lease. In particular, BC5 outlines how on initial recognition of a lease, an entity assesses whether temporary differences arise in order to determine whether to recognise deferred tax. To do this an entity must determine whether any tax deductions received on lease payments are attributable to either the lease asset (ie, because the deductions relate to the expenses arising from the lease) or to the lease liability (ie, because the deductions relate to the repayment of the lease liability and interest expense). BC6 goes on to state that ‘an entity applies judgement in determining whether tax deductions relate to the lease asset or lease liability, having considered the applicable law.’

19. We believe that the decision over whether a tax deduction relates to the lease asset or lease liability will be a challenging area for preparers and that further guidance is needed. One possibility could be to include simple examples which demonstrate how an entity has reached this decision. For example, to outline a situation in which the tax authority gives capital allowances/tax depreciation specifically for the asset held under the lease. In our view, the conclusion here would be that the tax deductions relate to the asset. A second example could relate to a tax authority which gives deductions for payments made to the

lessor. In our view, the conclusion reached in this instance would be that the tax deductions relate to the liability.

20. Without further specific guidance or examples, preparers may find application of the proposals challenging and could result in continued diversity in practice, limiting the expected benefits of the amendments.

Repositioning of guidance

21. We believe it would be helpful for some of the guidance currently included in the Basis of Conclusions to be included as part of the proposed amendments and therefore to form part of the main body of IAS 12. In particular:

- BC6 which explains how an entity would need to apply judgement in determining whether tax deductions relate to the lease asset or lease liability, having considered the applicable tax law.
- BC18 which provides guidance on how to deal with advance lease payments and paying initial direct costs with regards to the proposed amendments.
- BC21 which provides further guidance on the recoverability requirement for the recognition of deferred tax assets.
- BC26 which outlines how an entity might need to reassess any unrecognised deferred tax assets.