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Exposure Draft ED/2019/5 Deferred Tax related to Assets and Liabilities arising from a Single Transaction

Cover note and comment letter analysis

Objective

- 1 This paper provides a summary and analysis of comment letters received on EFRAG's Draft Comment Letter on the IASB's Exposure Draft ED/2019/5 *Deferred Tax related to Assets and Liabilities arising from a Single Transaction* (the 'ED').
- 2 The objective of this session is to agree to recommend the proposed final comment letter to the EFRAG Board for approval by written procedure.

Background

- 3 On 17 July 2019, the IASB issued the ED with the comment period ending on 14 November 2019.
- 4 The ED addresses the uncertainty in practice about how an entity applies the initial recognition exemption in paragraphs 15 and 24 of IAS 12 *Income Taxes* to transaction that give rise to both an asset and liability on initial recognition and may result in temporary differences of the same amount. In some cases, the exemption is applied, and in other cases it is not.
- 5 Under the proposed amendments, the initial recognition exemption in IAS 12 would not apply to a transaction that, at the time of the transaction, gives rise to equal and offsetting amounts of taxable and deductible temporary differences.
- 6 Paragraph 22A(b) of the ED also requires an entity to 'cap' the deferred tax liability (DTL) to the amount of the deferred tax asset (DTA) arising from the same transaction on initial recognition. This means that, on initial recognition, the amount of the recognised DTA in effect determines the DTL arising from the same transaction. The ED does not provide guidance on whether an entity should continue to cap the amount of the DTL to the corresponding DTA in subsequent periods in the event that the DTA can be recognised in future periods. The ED also considers that the recognition 'cap' could apply in cases of recoverability issues in relation to the DTA but does not expand on other situations (reasons) that might result in unequal amounts of DTA's and DTL's.

EFRAG's preliminary views

- 7 EFRAG published its draft comment letter (DCL) on the ED on 13 September 2019 and requested comments by 25 October 2019.
- 8 In its DCL, EFRAG supported the IASB's efforts to address the current diversity in initial recognition of deferred tax for single transactions that give rise to an asset and a liability. EFRAG also supported the proposed transactional requirements including

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the optional transition relief in relation to the recoverability requirement for DTA. However:

- (a) EFRAG questioned whether the IASB's approach ('gross method'), that considers the unit of account in IAS 12 as being the asset and the liability rather than as a single transaction, is the best approach given its complexity. EFRAG noted that under the proposed approach, entities will be required to separately track the reversal of the taxable and deductible temporary differences in subsequent periods. This might create complexity, especially given that different tax rates could apply going forward and the reversal periods for the deductible and taxable temporary differences could be different. However, EFRAG acknowledged that it is likely that the systems developed by individual entities for tracking their tax effects of other assets and liabilities may compensate for this potential complexity.
 - (b) EFRAG also expressed concerns with the recognition 'cap' in paragraph 22A(b) for a DTL, and the consequences of this proposal in subsequent periods. EFRAG recommended that the recognition 'cap' be removed. EFRAG did not elaborate on the consequences of removing the recognition 'cap' and the effects on the accounting in subsequent periods.
- 9 Given the questions regarding the approach proposed in the ED and the concerns identified by EFRAG regarding the application of the recognition 'cap', EFRAG included the following questions to constituents in its DCL:
- (a) EFRAG observes that the issue could have been addressed more simply by developing, for example, an IFRS Interpretation Committee Agenda Decision. This could avoid the complexity introduced by the ED. Do you agree with EFRAG that a simpler solution could have been developed?
 - (b) If the IASB continues standard setting activity, do you agree with EFRAG's recommendation that the recognition 'cap' should be removed?
 - (c) If you are not using a similar approach to that proposed in the ED, do you expect significant complexity in transitioning to the approach proposed in the ED?
 - (d) Do you have other concerns with the application of the proposed amendments?

Summary of constituents' views

List of constituents

- 10 As at 29 October 2019, five comment letters have been received responding to EFRAG's DCL.

Name of constituent	Country	Type / Category
ThyssenKrupp	Germany	Preparer
Danish Accounting Standards Committee (DASC)	Denmark	National Standard Setter
Accounting Standards Committee of Germany (ASCG)	Germany	National Standard Setter
Comissao de Normalizacao Constabilistica (CNC)	Portugal	National Standard Setter
Instituto de Contabilidad y Auditoría de Cuentas (ICAC)	Spain	National Standard Setter

General comments

- 11 Only two respondents (ThyssenKrupp and the ASCG) agreed with the IASB proposals, although both respondents noted some considerations in respect to the recognition 'cap' in paragraph 22A(b) of the ED. The remaining three respondents had provided different views on the ED proposals.
- 12 The responses to EFRAG's questions to constituents are summarised in the paragraphs below.

Do you agree with EFRAG that a simpler solution could have been developed – for example IFRS Interpretation Committee Agenda Decision?

- 13 Three respondents agreed with EFRAG that a simpler solution should have been developed but did not agree that the issue could be solved through an IFRS Interpretations Committee Agenda Decision. One of these respondent (DASC) thought that the issue could have been addressed through an IFRS Interpretation Committee Agenda Decision.
- 14 Another respondent (CNC) considered that the 'gross approach' will add significant complexity and suggested the 'net approach'. Another respondent (ICAC) also considered that the 'gross approach' adds complexity to the Standard and suggested to explore a simpler solution.
- 15 The other two respondents (ThyssenKrupp and ASCG) generally agreed with the ED proposals.
- 16 The three respondents that disagreed with the ED proposals provided different views on how to address the issue:
 - (a) One respondent (CNC) agrees that the initial recognition exemption should be applied to lease contracts when the conditions set out in the ED are met. However, if the conditions are not met temporary differences resulting from a single transaction represent a single unit of account (in such cases this respondent supports a net approach net approach).
 - (b) One respondent (DASC) noted that a far better and less burdensome solution would be to amend IAS 12 to say that the initial recognition exemption is not applicable to lease contracts and decommissioning transactions. However, this respondent indicates that the IASB should consider if there are other/better ways of addressing the issue, and if not, it should not proceed with the ED.
 - (c) One respondent (ICAC) indicated that the proposed gross approach might be complex to apply. This respondent also recommended that the IASB explore other cases where the recognition exemption does not allow deferred tax to be recognised. For example, non-monetary contribution of assets.

Do you agree with EFRAG's recommendation that the recognition 'cap' should be removed?

- 17 Two respondents (ThyssenKrupp, DASC) specifically supported **removing** the recognition 'cap', but for different reasons:
 - (a) One respondent (ThyssenKrupp) noted that the recognition 'cap' would not be effective in practice as DTL generally allow the recognition of DTA for the same amount (implying that the recognition 'cap' is not needed). This respondent agreed with EFRAG's recommendation to remove the recognition 'cap'.
 - (b) One respondent (DASC) did not agree with the recognition 'cap' citing conceptual issues and complexity in its application particularly because they

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thought it would require costly and on-going monitoring of the DTA and DTL at an individual asset level.

- 18 One respondent (CNC) supported a 'net approach' and explained that such an approach was compatible with the existence of a recognition 'cap' under the gross method proposed by the ED.
- 19 One respondent (ICAC) indicated that if the 'gross approach' is established, it could be premature to remove the recognition 'cap'. This respondent considered that the recognition 'cap' maintains the offsetting amounts of both the DTA and the DTL, which is condition to do not affect the assessment of the lease asset or lease liability.
- 20 One respondent (ASCG) supported the recognition 'cap' but added the following suggestions and considerations for the IASB:
 - (a) Clarify the application of the recognition 'cap' in paragraph 22A of the ED on initial recognition and in subsequent periods and provide an illustrative example. This respondent noted that BC24 of the ED explains that the recognition exemption would continue to apply to the part of the DTL that exceeds the amount for the corresponding DTA on initial recognition. However, it was not clear whether if the case of the proposals in an entity would continue to cap the amount of the DTL to the corresponding amount of DTA in subsequent periods.
 - (b) The ED considered only one cause leading to the situation where the recognition 'cap' would need to be applied - the recoverability requirement according to paragraph 24 of IAS 12. However, there could be other reasons for having unequal amounts of DTA's and DTL's liabilities, which are not addressed in the ED. For example, when tax rates are expected to change in the future. The amount of the DTA can even exceed the amount of the DTL. Therefore, this respondent urged the IASB to clarify in the main body of the Standard how an entity shall apply the initial recognition exemption to any portion of the DTL that exceeds the DTA and vice versa regardless of the reason for that situation.

Do you expect significant complexity in transitioning to the approach proposed in the ED?

- 21 Three respondents (DASC, CNC, ICAC) considered the proposals in the ED would be complex to apply mainly because it would be complex to track over time at an individual asset level. One respondent (DASC) noted that the IASB should consider if there are other/better ways of addressing the issue and therefore should not proceed with the ED.
- 22 The ASCG specifically stated that they did not share EFRAG's concerns about the complexity of the gross approach under which the unit of account is the separate asset and liability arising from the single transaction. Based on their experience, tracking the deferred tax assets and liabilities separately from each other is common practice in their jurisdiction and, is consistent with the general principles of IAS 12.

Do you have other concerns with the application of the proposed amendments?

- 23 The main application concerns were around the application of the recognition 'cap' at initial recognition and its implications in subsequent periods. In this regard, the ASCG noted the following:

'It remains unclear whether an entity should continue to cap the amount of the deferred tax liability to the corresponding amount of the deferred tax asset in subsequent periods. From the proposed wording in para. 22A – "In that situation, on initial recognition of the transaction, an entity recognises: [...]" – it could be inferred

that the cap relates only to the initial recognition. If so, an entity would recognise an amount of the deferred tax liability which exceeds the amount of the corresponding deferred tax asset and, consequently, a deferred tax expense in profit or loss according to para. 58 of IAS 12 in subsequent periods. On the other hand, and according to para. 22(c) of IAS 12, the initial recognition exemption applies to both, the date of initial recognition, and subsequent periods. Therefore, we recommend the IASB clarify the application of the proposed para. 22A subsequent periods and to provide an illustrative example.'

- 24 As explained in paragraph 20(a), one respondent (ASCG) asked for clarification regarding situations, other than concerns on 'recoverability', that could give rise to unequal amounts of DTA's and DTL's on initial recognition. This respondent also noted that:

'BC25 and BC 26 of the ED explain the reasons why the proposed amendments do not address the reassessment of unrecognised deferred tax assets. While we agree with these explanations, we fail to see how an entity would have to account for the portion of the deferred tax liability that it did not recognise applying the proposed requirement in para. 22A(b), if it subsequently reassessed the unrecognised deferred tax asset from the same transaction in accordance with para. 37 of IAS 12.'

EFRAG Secretariat recommendation on EFRAG's proposed final comment letter

- 25 The EFRAG Secretariat considered the various views expressed by the five respondents:
- (a) *View A: The net approach* - the EFRAG Secretariat notes that EFRAG TEG rejected the net approach when it discussed the approach at its EFRAG TEG webcast meeting on 6 September 2019. In its DCL EFRAG notes that the gross approach under IAS 12 is conceptually more correct because IFRS 16 *Leases* establishes that a lease gives rise to an asset and a liability for the lessee. Furthermore, the EFRAG Secretariat considers that tracking the deferred tax assets and liabilities separately from each other will be required under both the net approach and the gross approach, as one cannot appropriately determine the net DT position without monitoring DTA and DTL at an individual asset/liability level. Therefore, the EFRAG Secretariat considers that it would be inconsistent with the preliminary views in EFRAG's DCL and other responses to recommend the net approach.
 - (b) *View B: Do not proceed with the ED* – As EFRAG acknowledges in its DCL, there is diversity in practice which has become more prevalent under IFRS 16. On this basis, the EFRAG Secretariat does not recommend this view.
 - (c) *View C: Support the proposals other than recognition 'cap'* – The EFRAG Secretariat considers that if the recognition 'cap' is removed, preparers will need to revert to the existing principles in IAS 12 to account for any differences that might arise between the DTA and the corresponding DTL on initial recognition, as well as subsequent periods. This may result in different interpretations.
 - (d) *View D: Support the proposals and ask the IASB to reconsider the provisions of paragraph 22A* - to clarify the application of the recognition 'cap' both at initial recognition and in subsequent periods and discuss other cases that could result in unequal amounts of DTA's and DTL's. This view is partly in line with EFRAG's DCL in that it would address the diversity in practice and recommend the IASB to clarify the application of the recognition 'cap' at initial recognition and future periods (which might address (some of) EFRAG's concerns in EFRAG's DCL)

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- 26 For the reasons explained above, the EFRAG Secretariat considers that View D is the best option. We have amended EFRAG's DCL to reflect this view.

Questions for EFRAG TEG

- 27 Does EFRAG TEG agree with the EFRAG Secretariat analysis and recommendations based on the comment letters received?
- 28 Does EFRAG TEG agree to recommend the proposed final comment letter to the EFRAG Board for approval by written procedure?

Agenda Papers

- 29 In addition to this cover note, the following papers have been provided for this session:
- (a) Agenda Paper 07-02: *Proposed final comment letter (marked-up version)*; and
 - (b) Agenda Paper 07-03: *Proposed final comment letter (clean version)*.