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International Accounting Standards Board
7 Westferry Circus, Canary Wharf
London E14 4HD
United Kingdom

[XX Month 2019]

Dear Mr Hoogervorst,

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

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on Exposure Draft ED/2019/5 *Deferred Tax related to Assets and Liabilities arising from a Single Transaction* issued by the IASB on 17 July 2019 (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 Standards in the European Union and European Economic Area.

EFRAG notes that the issue being addressed in the ED is not new and understands that diversity in practice has existed for some time. However, we agree that the issue has become more significant with many more leases being recognised with the introduction of IFRS 16 *Leases* than when applying IAS 17 *Leases*. We therefore support the IASB's efforts to address the issue and help reduce diversity in practice in the accounting for deferred tax for such transactions.

EFRAG supports questions whether the IASB's proposed 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. In our view, this is consistent with the principles in IAS 12. is the best approach given the complexity. However, wWe also have concerns with understanding the implications of the recognition 'cap' in paragraph 22A(b) for a deferred tax liability, and the consequences accounting of this proposal in subsequent periods.

EFRAG supports the proposed retrospective application with transition relief that would permit a company to assess the recoverability of deferred tax assets only at the beginning of the earliest comparative period presented, reflecting the facts and circumstances at that date.

EFRAG's detailed comments and response to the question in the ED are set out in the Appendix.

*EFRAG Comment Letter – Deferred Tax related to Asset and Liabilities arising from a
Single Transaction*

If you would like to discuss our comments further, please do not hesitate to contact Isabel Batista, Ricardo Torres or me.

Yours sincerely,

Jean-Paul Gauzès
President of the EFRAG Board

Appendix - EFRAG's responses to the questions raised in the ED

Question 1

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

EFRAG's response

EFRAG supports 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 questions 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 the complexity. EFRAG supports the IASB's proposed approach that considers the unit of account in IAS 12 as being the asset and the liability rather than as a single net asset or liability transaction. However, ~~w~~We also have concerns with understanding the recognition 'cap' in paragraph 22A(b) for a deferred tax liability, and the ~~consequences~~ accounting of this proposal in subsequent periods.~~

EFRAG supports the proposal to require entities to apply the amendments retrospectively with earlier application permitted. EFRAG also supports the optional transition relief in relation to the recoverability requirement for deferred tax asset.

Potential impacts of the proposed amendments

- 1 EFRAG understands that diversity in practice has existed for some time in relation to single transactions that give rise to an asset and a liability, such as leases and decommissioning liabilities under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. We agree that the issue has become more prevalent, in particular with many more leases being recognised with the introduction of IFRS 16 *Leases* than when applying the IAS 17 *Leases*. We consider that the proposals will reduce diversity in practice for transactions addressed in the ED.
- 2 EFRAG understands that the potential impacts of the proposed amendments, and costs associated with implementing them, would depend upon an entity's current approach to deferred tax accounting for such transactions. ~~For example, entities that currently apply the initial recognition exemption in paragraphs 15 and 24 of IAS 12 separately to the temporary differences arising on the asset and the liability, might no longer be permitted to do so. EFRAG acknowledges that there may be other approaches applied in practice that could also be affected by the proposed amendments.~~
- 3 As explained in paragraph BC6, an entity needs to apply judgement when determining whether temporary differences relate to the asset or the liability, based on the applicable tax law. Paragraphs BC7(a) and BC7(b) note that temporary differences arise only when the entity determines that tax deductions relate to the liability (for example a lease liability). In this case, temporary differences arise on initial recognition of the lease asset and the lease liability. EFRAG understands that some entities currently apply the initial recognition exemption to both the temporary difference on the asset and the liability. As a result, under IAS 12 no deferred tax would be recognised on initial recognition or in subsequent periods. For these entities, the proposed amendments might have a significant impact.

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- ~~4— On the other hand, if the tax deductions relate to the lease asset, no temporary differences would arise in respect of the lease transaction and the initial recognition exemption does not apply. Consequently, no deferred tax would be recognised on initial recognition. However, deferred tax would be recognised when temporary differences arise in subsequent periods.~~
- ~~5— In developing the proposed amendments, the IASB considered that the recognition of deferred tax on the transactions addressed in the ED, should not depend on whether the tax deductions relate to the asset or the liability as this creates an inconsistency with the general principles in IAS 12.~~

Application of the gross approach

- ~~6— EFRAG supports the action by the IASB to address the existing diversity in practice, but questions whether the IASB's approach is the best approach given the complexity. The ED proposes a gross method approach—that considers the units of account in IAS 12 as being the asset and the liability rather than as a single transaction. EFRAG notes that IFRS 16 establishes that a lease gives rise to an asset and a liability for the lessee and, consequently, considers that the gross approach under IAS 12 is conceptually more correct. 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. At the same time, 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.~~

Application of paragraph 22A of the ED – the recognition 'cap'

- ~~4— EFRAG considers notes that paragraph 22A of the proposals, particular paragraph 22A(b) may be complex to apply in practice, particularly in subsequent periods. This paragraph proposes to limit the recognition of a deferred tax liability to the amount of the deferred tax asset on initial recognition – referred to as the recognition 'cap'. In other words, if on initial recognition a deferred tax asset cannot be recognised, or partly recognised, because of recoverability issues or other matters, the related deferred tax liability is also not recognised. Paragraph BC24 of the ED explains that, in such cases, it is necessary to apply the initial recognition exemption to the part of the deferred tax liability that exceeds the deferred tax asset. EFRAG generally understands this to be a pragmatic solution to avoid adjusting the carrying amount of the related asset by this excess amount or recognising the day one loss for this amount, and thus, to meet the objective of the recognition exception, which is explained in paragraph 22(c) of IAS 12. agrees that it makes sense to apply the initial recognition exemption to the 'excess' amount, as this is the very issue the recognition exemption tries to solve. Otherwise a question would arise about whether it should be recognised in profit or loss (resulting in a so-called day 1 loss) or as part of the asset (lease asset or another corresponding asset). We consider it would be helpful to include paragraph BC24 in the body of the final amendment, to explain the IASB's reasoning to 'cap' the deferred tax liability in cases when the deferred tax liability exceeds the amount of the related deferred tax asset.~~
- ~~5— However, EFRAG does not agree that the recognition of a specific deferred tax asset should be used as a reference to cap a deferred tax liability arising from the same transaction, as required by paragraph 22A(b). We consider that this is contrary to the general principle in IAS 12 that all deferred tax liabilities should be recognised, unless the initial recognition exemption in IAS 12 applies. As explained in paragraph BC24 of the ED, we understand that this is the intention of the proposal on initial recognition.~~

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- ~~Further~~ However, 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.
- 6 From the proposed wording in paragraph 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 a deferred tax liability that exceeds the corresponding deferred tax asset and, consequently, a deferred tax expense in profit or loss according to paragraph 58 of IAS 12 in subsequent periods. On the other hand, and according to paragraph 22(c) of IAS 12, the initial recognition exemption applies at the both, the date of initial recognition, and in subsequent periods. In this case, an entity would not recognise subsequent changes to the unrecognised deferred tax liability.
- 7 Therefore, if the recognition ‘cap’ were to be retained, we recommend the IASB clarify the application of the proposed paragraph 22A(b) in subsequent periods and to provide an illustrative example.
- 8 We consider that clarifying paragraph 22A(b) would help understand how an explain how an entity should account for the reassessment of unrecognised deferred tax assets (that were not recognised under paragraph 22A(a)), and the implications on the portion of the deferred tax liability that an entity did not recognise when applying the recognition ‘cap’ under paragraph 22A(9b). As explained in paragraphs BC25 and BC 26 of the ED, reassessment of unrecognised deferred tax assets is not addressed in the ED.
- ~~7~~ In addition, the introduction of the cap creates both conceptual and practical difficulties:
- ~~(a)~~ the existence of the cap conflicts with the unit of account being the individual asset and the individual liability. If the asset and liability arising from a lease are deemed to be separate units of account, there appears to be no reason why the amount of an associated deferred tax asset should limit the amount of a deferred tax liability; and
 - ~~(b)~~ as the asset and liability are separate units of account, potentially recorded in different systems, reinstating the “single transaction” for the purposes of measuring the deferred tax liability creates cost and complexity without, in our view, providing benefits to users.
- ~~If paragraph 22A(b) were to be retained, EFRAG considers that paragraph 22(c) would also need to be reviewed considered in relation to the deferred tax liability which might not have been recognised because of the limitation imposed by paragraph 22A(b). EFRAG recommends the IASB to clarify the interaction between paragraph 22A(b) and paragraph 22(c) and provide an illustrative example to help in the application of these paragraphs in subsequent periods.~~
- 9 For these reasons EFRAG recommends that the ‘cap’ be removed. the IASB to reconsider the application of paragraph 22A, and the accounting of this proposal in subsequent periods.

Other considerations related to leases

- 810 EFRAG agrees that an entity would apply the existing requirements in IAS 12 to any taxable temporary differences arising from making advance lease payments or paying initial direct costs.

Transition and effective date

- 911 EFRAG generally supports retrospective application of new requirements and, consequently, supports the proposal to require entities to apply the amendments retrospectively with earlier application permitted. In this case, EFRAG also supports

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the proposed transition relief to permit an entity to assess the recoverability of deferred tax assets only at the beginning of the earliest comparative period presented, reflecting the facts and circumstances at that date.

~~40~~12 We acknowledge that retrospective application of the proposed amendments would require an entity to assess the recoverability requirement on initial recognition of the transaction that gave rise to the temporary differences. For both leases and decommissioning obligations, assessing the recoverability requirement could in some cases (when the transaction took place some time ago) be impracticable or result in undue costs with limited benefits for users of the financial statements.