You can submit your comments on EFRAG's draft comment letter by using the 'Express your views' page on EFRAG's website, then open the relevant news item and click on the 'Comment publication' link at the end of the news item.

Comments should be submitted by [date].

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

[XX Month 201X]

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 Singles 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 the previous lease Standard.

EFRAG agrees with the proposal to restrict the application of the recognition exemption in IAS 12 Income Taxes so that it would not apply to transactions such as leases and decommissioning liabilities when the initial temporary differences arising from these transactions are of the same amount.

EFRAG considers that the proposed amendments will reduce diversity in practice and improve the consistency in the accounting for deferred tax for economically similar transactions.

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.

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

Notes to constituents – Summary of proposals in the ED

Introduction

1 In 2018, the IFRS Interpretations Committee (IFRS IC) received a request asking whether the initial recognition exemption in paragraphs 15 and 24 of IAS 12 (recognition exemption) applies to a transaction that results in the recognition of an asset and a liability in a situation in which an entity receives tax deductions only for payments made, when those payments are made. An example illustrating the issue and the application of the proposed amendments is provide in the IASB publication 'In Brief – Deferred Tax related to Assets and Liabilities arising from a Single Transaction'.

2 Depending on the applicable tax law, and whether the tax deductions relate to the asset or the liability, such transactions may give rise to equal and offsetting temporary differences which, applying the general principle in IAS 12 would result in the recognition of both deferred tax assets and liabilities. Typical examples are the recognition of a lease under IFRS 16 Leases (which involves recognising a lease asset and a lease liability), and a decommissioning provision under IAS 37 Provisions, Contingent Liabilities and Contingent Assets (with the counter-entry recognised as part of the related asset).

3 IAS 12 prohibits an entity from recognising deferred tax arising from the initial recognition of an asset or a liability in particular situations (initial recognition exemption). The IFRS IC observed that is uncertainly in practice about how an entity applies the initial recognition exception to transactions that give rise to both an asset and a liability on initial recognition and may result in temporary differences of the same amount. Currently, different practices exist mainly because of the judgement required to decide whether the tax deductions relate to the recognised asset or liability as explained in BC7 of the ED. The IFRS IC recommended that the IASB develop a narrow-scope amendment to IAS 12 to address the issue.

*4 The proposed amendment would narrow the applicability of the recognition exemption in IAS 12 to transactions that do not give rise to equal and offsetting amounts of taxable and deductible temporary differences. In other words, the recognition exemption would **not apply** to temporary differences of the same amount in cases such as leases under IFRS 16 and decommissioning obligations under IAS 37. This is because the recognition exemption is not needed on initial recognition when an entity would otherwise recognise a deferred tax asset and liability of the same amount. Such cases would not require any adjustment to the carrying amount of the related asset or liability nor would it have any effect on profit or loss as explained in BC11 of the ED.*

Ability to recognise deferred tax assets

5 The proposed amendments add paragraph 22A to IAS 12. Paragraph 22A explains that a transaction that is not a business combination may lead to the initial recognition of an asset and liability that, at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss). Equal amounts of taxable and deductible temporary differences may arise from the initial recognition of that asset and liability. In that situation, on initial recognition of the transaction, an entity recognises:

(a) a deferred tax asset for the deductible temporary difference to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised; and

(b) a deferred tax liability for the taxable temporary difference. However, the amount of the deferred tax liability ***shall not exceed*** *the amount of the deferred tax asset recognised in accordance with paragraph 22A(a).*

6 The ED explains in paragraph BC21 that when the initial recognition of a lease or decommissioning obligation gives rise to equal amounts of taxable and deductible temporary differences, those differences would generally relate to the same taxation authority and taxable entity. It is possible, therefore, that an entity would meet the recoverability requirement for recognition of a deferred tax asset solely through the future reversal of the taxable temporary difference arising from the same transaction. However, an entity would not meet the recoverability requirement to the extent that these temporary differences reverse in different periods and the tax law disallows the carry forward or carry back of tax losses.

7 Paragraph BC22 of the ED adds that when an entity assesses the recoverability requirement for a deferred tax asset independently of other sources of profit (that is, the assessment is only with reference to the taxable temporary difference arising from the transaction), the entity is more likely not to recognise some portion of a deferred tax asset related to decommissioning obligations than a deferred tax asset related to leases. This is because the patterns of reversal of taxable and deductible temporary differences might often be similar for leases, but not for decommissioning obligations, which are typically settled only towards the end of the useful life of the related asset. In such cases it is possible that the deferred tax asset will not meet the recoverability criteria in IAS 12. Therefore, paragraph BC23 explains that the recognition exemption should continue to apply to the extent that an entity would otherwise recognise unequal amounts of deferred tax assets and liabilities. This has the same outcome as limiting the deferred tax liability to the amount of the related deferred tax assets.

8 The IASB decided that the proposed amendments should not address the reassessment of unrecognised deferred tax assets. This is because such reassessment is already addressed in paragraph 37 of IAS 12 which requires an entity to reassess any unrecognised deferred tax assets at the end of each reporting period.

Other considerations related to leases

9 Applying IFRS 16, an entity initially measures a lease asset and a lease liability at the present value of the lease payments that are not paid at the commencement date of the lease. An entity also recognises advance lease payments and initial direct costs incurred as part of the cost of a lease asset.

10 Making advance lease payments or paying initial direct costs do not give rise to equal and offsetting temporary differences. An entity would therefore apply the existing requirements in IAS 12 to any taxable temporary difference arising from such payments. The proposed amendments would still apply to equal and offsetting temporary differences arising from the recognition of the lease liability and the related component of the lease asset.

11 Accordingly, the IASB concluded that advance lease payments and initial direct costs do not affect the proposed amendments.

Transition and effective date

12 The ED proposes to require entities to apply the amendments retrospectively with earlier application permitted, but to provide relief in relation to the recoverability requirement for deferred tax assets.

13 The IASB decided to make the proposed transition relief optional. The different views on the existing requirements in IAS 12 means that some entities may already have applied an accounting policy that is aligned with the proposed amendments – making the transition relief mandatory could result in some entities being required to change their accounting solely because of the transition relief. The IASB considered that this outcome would be undesirable because it could result in additional costs for some entities without significant additional benefits.

First-time adopters

14 The ED provides transition relief for first-time adopters. In the absence of the transition relief, an entity would be required to assess the recoverability (for tax assets and tax liabilities) requirement at the date of the transaction.

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 agrees with the proposal to amend paragraphs 15 and 24 of IAS 12 and to add paragraph 22A to restrict the application of the initial recognition exemption so that it would not apply to transactions such as leases and decommissioning liabilities when the temporary differences arising from these transactions are equal and offsetting.

EFRAG considers that these proposals will reduce diversity in practice and improve the consistency in the accounting for deferred tax for economically similar transactions.

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.

15 EFRAG notes that the issue being addressed in the ED is not new and understands that diversity in practice has existed for some time. 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 previous leases Standard.

Restricting the application of the initial recognition exemption

16 EFRAG agrees with the proposal to amend paragraphs 15 and 24 of IAS 12 to restrict the application of the recognition exemption so that it would not apply to transactions such as leases and decommissioning liabilities when the temporary differences arising from these transactions are equal and offsetting. In such cases, we agree that the initial recognition exemption in IAS 12 is not needed, and an entity should apply the general principles in IAS 12.

17 EFRAG considers that the proposed amendments will provide clarification on how to apply IAS 12 to transactions that give rise to an asset and a liability of equal amounts on initial recognition. The proposals would reduce diversity in practice and

align the deferred tax accounting for such transactions with the general deferred tax principles in IAS 12. This would increase comparability and result in more useful information for users of financial statements.

18 In our view, using a lease as an example, the deferred tax principle should be the same regardless of whether the tax deductions are attributable to the lease asset or to the lease liability. Currently this is not the case because, under IAS 12, the initial recognition exemption would depend on the attribution of the tax deductions and/or whether the lease asset and lease liability are considered 'integrally linked'. The proposed amendments will only permit the application of the initial recognition exemption when it is needed for its intended purpose. That is, when the temporary differences at initial recognition are of unequal amounts (resulting in an unequal deferred tax asset and deferred liability on initial recognition). The proposed amendments will therefore bring consistency in the accounting for deferred tax, in particular the application of the initial recognition exemption, for economically similar transactions.

Ability to recognise deferred tax assets

19 Under paragraph 22A of the proposals, the recognition of a deferred tax asset would be recognised considering the recoverability requirement in IAS 12, and the amount of the related deferred tax liability must not exceed the amount of the deferred tax asset. In other words, to the extent that an entity does not recognise a deferred tax asset because of the recoverability requirement, it would also not recognise a deferred tax liability. Therefore, the ED proposes that the recognition exemption should continue to apply if an entity would otherwise recognise unequal amounts of deferred tax assets and liabilities. EFRAG agrees that the outcome seems consistent with the proposal in paragraph 22A(b) to limit the amount of the deferred tax liability to the amount of the deferred tax asset. Overall, EFRAG agrees that this proposal is consistent with the underlying principles in IAS 12 on the recognition of deferred tax assets.

Other considerations related to leases

20 EFRAG agrees with the IASB's conclusion in paragraphs BC16-BC18 of the Basis for Conclusions of the ED that making advance lease payments or paying initial direct costs do not give rise to equal and offsetting temporary differences. Such payments are part of the cost of a lease asset. Therefore, we agree that an entity would apply the existing requirements in IAS 12 to any taxable temporary difference arising from such payments.

Transition and effective date

21 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 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.

22 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.