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 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 ~~the previous lease Standard.~~ 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 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.~~

However, we have some concerns with the proposed approach in the ED, which is based on a 'gross method' of accounting for deferred tax (by considering the asset and the liability that arise from the single transaction, separately). Under this approach, companies will be required to separately track the reversal of the taxable and deductible temporary differences in subsequent periods. In our view, this could be complex and costly to implement especially given that different tax rates could apply in subsequent periods and the reversal periods for the deductible and taxable temporary differences could be different. We also have concerns with the recognition 'cap' in paragraph 22A(b) for a deferred tax liability, and the consequences 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.

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 provided 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 (referred to as a right-of-use asset in IFRS 16) 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).~~and its corresponding 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 there is uncertainly in practice about how an entity applies the initial recognition exemption 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.~~In some cases, the exemption is applied, and in other cases it is not. The IFRS IC recommended that the IASB develop a narrow-scope amendment to IAS 12 to address the issue.

4 Under the proposed ~~amendment would narrow the applicability of~~amendments, the initial recognition exemption in IAS 12 would not apply to transactions that ~~do not~~at the time of the transaction 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 a deferred tax 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 paragraph 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 initial 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, on initial recognition.*

8 *The IASB decided that the proposed amendments should not address the subsequent 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~~. It also provides 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~~supports the ~~proposal~~IASB's efforts to ~~amend paragraphs 15 and 24 of IAS 12 and to add paragraph 22A to restrict~~address the ~~application of~~current diversity in applying the initial recognition exemption ~~so that it would not apply~~in IAS 12 to transactions ~~such as leases and decommissioning liabilities when the temporary differences arising from these transactions are equal and offsetting.~~

that give rise to an asset and a liability for accounting purposes. EFRAG considers that ~~these proposals will~~ the proposed amendments would reduce diversity in practice ~~and improve the consistency~~ in the accounting for deferred tax for ~~economically similar~~such transactions.

However, we have some concerns with the proposed approach in the ED, which is based on a 'gross method' of accounting for deferred tax (by considering the asset and the liability that arise from a single transaction, separately). Under this approach, companies will be required to separately track the reversal of the taxable and deductible temporary differences in subsequent periods. In our view, this can be complex and costly to do.

We also have concerns with the recognition 'cap' in paragraph 22A(b) for a deferred tax liability, and the consequences 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

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~~.~~ in relation to transactions that give rise to an asset and a liability for accounting purposes, 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 previous leases Standard. Therefore, we consider that the proposals will reduce diversity in practice for transactions addressed in the ED.

16 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.

17 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.

18 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.

19 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.

Restricting the application of the initial recognition exemption

~~16~~20 ~~EFRAG agrees with~~EFRAG supports the IASB's efforts to address the existing diversity. However, we note that 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~~that give rise to an asset and ~~decommissioning liabilities~~a liability when the temporary differences arising from these transactions are equal and offsetting~~.~~, is one way to solve the existing diversity. In ~~such cases~~this case, 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*~~

21 ~~Under~~ The ED proposes a 'gross method' approach – that considers the unit of account in IAS 12 as being the asset and the liability rather than as a single transaction. 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.

22 EFRAG considers that a similar outcome to one in the ED could be achieved by applying a 'net approach', in which the asset and the liability that arise for accounting purposes would be considered as integrally linked and deferred tax would be calculated on the net temporary difference. For tax purposes, the tax authority would generally consider the transaction to be a single transaction on which it gives a single set of tax deductions.

23 Applying a 'net approach' would typically result in a net temporary difference of zero on initial recognition of the asset and liability, and therefore the initial recognition exemption would not apply. In subsequent periods, the deferred tax accounting would continue to be based on the net temporary difference, which depending on the entities reporting systems, could potentially make the subsequent accounting easier than the approach proposed in the ED. We consider that it would not be inconsistent with IAS 12 to apply a 'net approach'. This is because the asset and liability are integrally linked, and considered as a single transaction for tax purposes, and therefore could be considered as a single unit of account.

Application of paragraph 22A of the ED

24 EFRAG considers 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 ~~asset would be recognised considering the recoverability requirement in IAS 12, and the amount of the related deferred tax~~ liability ~~must not exceed~~to the amount of the deferred tax asset~~.~~ on initial recognition. In other words, ~~to the extent that an entity does not recognise~~if on initial recognition a deferred tax asset cannot be recognised, or partly recognised, because of ~~the~~ recoverability ~~requirement, it would~~issues or other matters, the related deferred tax liability is 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~~recognised. Paragraph BC24 of ~~deferred tax assets and liabilities. EFRAG agrees that the outcome seems consistent with the proposal in paragraph 22A(b) to limit the amount~~the ED explains that, in such cases, it is necessary to apply the initial recognition exemption to the part of the deferred tax liability ~~to the amount~~that exceeds the deferred tax asset. EFRAG generally 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

~~deferred tax~~ asset~~. Overall, EFRAG agrees that this proposal is consistent with the underlying principles in IAS 12 on the~~ (lease asset or another corresponding asset). Nonetheless, we consider it would be helpful to include paragraph BC24 in the body of the final amendment, to explain the reasoning to 'cap' to the deferred tax liability.

25 In principle, EFRAG does not agree that the recognition of a specific deferred tax asset should be used as a reference to recognise ('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 on the accounting for deferred tax liabilities. The stricter recognition criteria in IAS 12 apply only to deferred tax assets.

~~19~~26 Furthermore, paragraph 22A(a) of the ED focuses on cases when the deferred tax asset could be lower than a deferred tax liability because of recoverability issues. However, in practice this is not the only reason a deferred tax ~~assets~~asset and the related deferred tax liability could differ. For example, average tax rates can be different in cases when the enacted tax law already foresees future progressive changes in tax rates which could lead to differences. We recommend that the IASB addresses such cases and include an illustrative example to help in the application of paragraph 22A at initial recognition and in subsequent periods.

27 As explained in paragraphs BC23-28, the IASB decided not to address the subsequent reassessment of unrecognised deferred tax assets because such reassessment is already addressed in paragraph 37 of IAS 12. Paragraph BC26 notes that an entity might reassess in a subsequent period that it can recognise a previously unrecognised deferred tax asset (that was not recognised because of recoverability issues). However, if an entity considers that it did not recognise a deferred tax asset because of the initial recognition exemption, then paragraph 22(c) of IAS 12 would preclude their subsequent recognition.

28 EFRAG considers that in subsequent periods paragraph 22(c) would also need to be 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.

29 For the reasons outlined above, EFRAG questions whether the proposed amendments present the best solution either from a conceptual point of view or a practical perspective.

30 EFRAG notes that if the IASB had proposed a 'net approach' (explained in paragraph 0) paragraph 22A would not be needed as an entity would not recognise a deferred tax asset or a deferred tax liability on initial recognition. In subsequent periods, an entity would continue to recognise deferred tax based on the net temporary difference, rather than on a 'gross basis'. A 'net approach' might be simpler and less costly to implement.

Other considerations related to leases

~~20~~31 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~~differences arising from ~~such~~making advance lease payments or paying initial direct costs.

Transition and effective date

~~21~~32 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~~33 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.

34 Overall, given the outlined complexity and questions relating to the subsequent accounting, EFRAG thinks that the IASB should consider a 'net approach' which would entail different transition provisions for entities currently using an approach similar to that proposed in the ED.

Question to constituents

35 Are you using an approach similar to that proposed in the ED? If so, what would be the impact if the IASB were to mandate a 'net approach'?

36 If you are not using an approach similar to that proposed in the ED, do you agree with EFRAG's concerns regarding the application of paragraph 22A in the ED? If not, please explain why.

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