8 January 2015

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir/Madam,

Re: Recognition of Deferred Tax Assets for Unrealised Losses (Proposed Amendments to IAS 12)

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft ED/2014/3 *Recognition of Deferred Tax Assets for Unrealised Losses (*Proposed Amendments to IAS 12), issued by the IASB on 20 August 2014 (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 in the European Union and European Economic Area.

EFRAG supports the core of the proposals in the ED. However, EFRAG has some concerns and wording suggestions that we recommend are taken into account when finalising the amendments to ensure that the welcomed clarifications are fully effective. These concerns and clarifications are described in detail in the Appendix.

If you would like to discuss our comments further, please do not hesitate to contact David Martin Garcia, Martin Svitek or me.

Yours faithfully,

Roger Marshall
Acting President of the EFRAG Board

APPENDIX

Question 1—Existence of a deductible temporary difference

The IASB proposes to confirm that decreases in the carrying amount of a fixed-rate debt instrument for which the principal is paid on maturity give rise to a deductible temporary difference if this debt instrument is measured at fair value and if its tax base remains at cost. This applies irrespective of whether the debt instrument's holder expects to recover the carrying amount of the debt instrument by sale or by use, ie by holding it to maturity, or whether it is probable that the issuer will pay all the contractual cash flows.

Do you agree with the proposed amendment? Why or why not? If not, what alternative do you propose?

EFRAG's response:

EFRAG agrees with the proposed amendments. However, EFRAG recommends that the example that illustrates paragraph 26(d) also explains that it is irrelevant, for the purpose of assessing whether a deductible temporary difference arises, whether the debt instrument is measured at FVPL or at FVOCI. In addition, we suggest that the wording of the example following paragraph 26(d) is amended in order to fit the requirements both in IFRS 9 and IAS 39.

1 EFRAG welcomes the proposal to clarify that the decrease below cost in the carrying amount of a debt instrument measured at fair value for which the principal is paid at maturity give rise to a deductible temporary difference.

2 EFRAG agrees that, while in a situation as the one described above, it is more intuitive that a deductible temporary difference arises where the entity expects to recover the carrying amount of the asset by sale, it is not self-evident in situations where the entity expects to recover the carrying amount of the asset just by holding the debt instrument until maturity. In the latter case, some have difficulties in identifying the tax benefits embodied in the resulting deferred tax asset. As explained in the Basis for Conclusions, the economic benefit embodied in the related deferred tax asset results from the fact that, at maturity, the holder of the debt instrument can achieve taxable gains without paying taxes on those gains because it has tax deductions of the same amount.

3 Although EFRAG believes that the conclusion should be the same regardless of whether the debt instrument is measured at FVPL or at FVOCI, EFRAG is aware that part of the confusion on the issue refers to the fact that some believe that deferred tax assets on unrealised losses are not realised for tax purposes unless they are accounted for in profit or loss (for example when objective evidence exists that the asset is impaired).

4 Therefore, EFRAG recommends that the example that illustrates paragraph 26(d) also explains that it is irrelevant, for the purpose of assessing whether a deductible temporary difference arises, whether the debt instrument is measured at FVPL or at FVOCI. This conclusion can be deduced however, from the illustrative example included as part of the proposed amendments to the non-mandatory guidance.

5 In addition, we believe that the fact pattern of the example, when referring to holding the asset until maturity, mostly uses the wording applicable in the IAS 39 *Financial Instruments: Recognition and Measurement* environment. Therefore, we suggest

that the fact pattern is amended in order to fit the requirements both in IFRS 9 *Financial Instruments* and IAS 39. If different wording was needed to fit both standards, the text relevant to IAS 39 should be clarified in a footnote as it is already done in paragraph IE6.

Question 2—Recovering an asset for more than its carrying amount

The IASB proposes to clarify the extent to which an entity's estimate of future taxable profit (paragraph 29) includes amounts from recovering assets for more than their carrying amounts.

Do you agree with the proposed amendment? Why or why not? If not, what alternative do you propose?

EFRAG's response:

EFRAG agrees with the IASB's proposed amendment but we suggest the IASB slightly redraft the first sentence and remove the last two sentences of paragraph 29A from the body of the standard. In addition, we suggest the IASB redraft paragraph 29A to include the expected assessment for liabilities (and not only for assets).

6 EFRAG agrees with the IASB's proposed amendment as it will reduce diversity in practice on how entities estimate future taxable profits against which deductible temporary differences are assessed for utilisation.

7 EFRAG agrees that the carrying amount of an asset does not limit the estimation of probable future taxable profit. Indeed, if the assessment of the recoverability of deferred tax assets were based on the assumption that all assets are recovered for their carrying amount, entities could not estimate any future profit at all and, therefore, deferred tax assets could never be recognised. This is also well illustrated by the example of the manufacturing entity included in paragraph BC13 of the Basis for Conclusions that accompany the proposed amendments.

8 However, EFRAG believes that the wording of paragraph 29A (first sentence) may lead to confusion when referring to "estimating future taxable profit in future periods <u>requires</u> assessing whether and to what extent it is probable (...)". In EFRAG´s view, that statement is appropriate only when taxable profit from other sources is insufficient for the utilisation of the deductible temporary differences or when the entity has a limited number of deferred tax assets subject to the assessment of utilisation. In other situations, we do not think that the application of paragraph 29A is practical because entities do not estimate future taxable profit on an asset by asset basis. Quite the contrary, entities usually estimate future taxable profits considering, as a starting point, their business plan. For that reason, we suggest that the IASB amend the proposed paragraph 29A so that it reads as follows: "estimating future taxable profit in future periods requires assessing whether and to what extent it is probable that the assets of the entity will be recovered for more than their carrying amount in those situations where an entity cannot assess the existence of sufficient future taxable profit on an entity basis". Otherwise, it may add unnecessary complexity into the standard.

9 In addition, while EFRAG generally supports the IASB's proposal to add paragraph 29A, we are more supportive of principle-based standards than prescribing specific rules. In our view, the first two sentences of paragraph 29A are sufficient to establish the principle. Therefore, we suggest that the last two sentences of paragraph 29A

are removed from the body of the standard and these arguments are retained in the Basis for Conclusions.

10 Finally, we suggest the IASB redraft paragraph 29A to include the expected assessment for liabilities (and not only for assets) when estimating future taxable profits. In our view, this applies in those situations where an entity cannot assess the existence of sufficient future taxable profit on an entity basis, it should be assessed whether it is probable that the liabilities of the entity will be settled for less than their carrying amount.

Question 3—Probable future taxable profit against which deductible temporary differences are assessed for utilisation

The IASB proposes to clarify that an entity's estimate of future taxable profit (paragraph 29) excludes tax deductions resulting from the reversal of deductible temporary differences.

Do you agree with the proposed amendment? Why or why not? If not, what alternative do you propose?

EFRAG's response:

EFRAG welcomes the proposal as we are aware that diversity in practice exists on this issue. However, EFRAG believes that paragraph 29(a)(i) is difficult to read and recommends that an illustrative example is introduced into the body of the Standard for clarification. In addition, we believe that the Standard should specify that the entity must also exclude the reversal of taxable temporary differences. Finally, we believe that it should be further explained in the Basis for Conclusions that the utilisation of deductible temporary differences is not assessed against future taxable profit for a period upon which income taxes are payable.

11 EFRAG welcomes the proposal as we are aware that diversity in practice exists on how entities estimate future taxable profits against which deductible temporary differences are assessed for utilisation.

12 EFRAG is aware that part of the confusion on the recognition of deferred tax assets arises from how entities interpret future taxable profit against which deductible temporary differences are assessed for utilisation (under paragraph 29 of IAS 12). In effect, some believe that probable taxable profits calculated for "assessment purposes" is determined excluding any deduction or reversal of deductible temporary differences and therefore they argue that taxable profit used for "assessment purposes" is not the same as "actual" taxable profit on which income taxes are payable (as defined in paragraph 5 of IAS 12). Others, however, believe that there is only one definition of taxable profit under IAS 12 as defined in paragraph 5 of the Standard. In their view, that definition is also used when determining probable taxable profits when assessing recognition of a deferred tax asset.

13 Because of this confusion, EFRAG believes that the wording of paragraph 29(a)(i) is difficult to read. Therefore, EFRAG believes that it would be helpful to introduce a short illustrative example in the body of the Standard to illustrate this issue. EFRAG proposes the following illustrative example:

14 Entity A bought a debt instrument with a nominal value of CU1,000. Its fair value on 31 December 2013 is CU800. A determines that there is a deductible temporary difference of CU200. A expects to hold the instrument until its maturity on 31 December 2014 and collect the CU1,000, reversing therefore the deductible temporary difference. In addition, A has a taxable temporary difference of CU50 that will also reverse on 31 December 2014. A expects that in 2014 its future taxable profit upon which income taxes are payable will be a loss of CU50. A's income tax rate is 30%.

15 **Step 1**: utilisation of deductible temporary differences because of the reversal of taxable temporary differences

Deductible temporary differences	200
Reversal of taxable temporary differences	(50)
Remaining amount to be tested for utilisation (step 2)	150

16 In step 1, entity A can recognise at least a deferred tax asset in relation to a deductible temporary difference of 50.

17 **Step 2**: utilisation of deductible temporary differences because of future taxable profit:

Expected tax loss (upon which income taxes are payable)	(50)
Minus reversal of taxable temporary differences (utilised in step 1)	(50)
Plus reversal of deductible temporary differences	200
Taxable profit for assessing the utilisation of deductible temporary differences	100

18 In step 2, entity A can recognise a deferred tax asset in relation to a deductible temporary difference of 100. Therefore, entity A would recognise a deferred tax asset of 45 ((50 [step 1] +100 [step 2]) x 30%)).

19 In addition, we believe that the Standard should specify that the entity must also exclude the reversal of taxable temporary differences as it is mentioned in paragraph IE34 of the illustrative example that accompanies the Standard.

20 Finally, we note that, as explained in paragraph IE38 of the illustrative example and implicit in paragraph 29(a)(i), the utilisation of deductible temporary differences is not assessed against probable future taxable profit (as defined in paragraph 5 of IAS 12). However given the confusion noted in paragraph 12 above we believe this should also be explicitly explained in the Basis of Conclusions.

Question 4—Combined versus separate assessment

The IASB proposes to clarify that an entity assesses whether to recognise the tax effect of a deductible temporary difference as a deferred tax asset in combination with other deferred tax assets. If tax law restricts the utilisation of tax losses so that an entity can only deduct tax losses against income of a specified type or specified types (eg if it can deduct capital losses only against capital gains), the entity must still assess a deferred tax asset in combination with other deferred tax assets, but only with deferred tax assets of the appropriate type.

Do you agree with the proposed amendment? Why or why not? If not, what alternative do you propose?

EFRAG's response:

EFRAG welcomes the proposed amendment to paragraph 27A of IAS 12. However, EFRAG suggests explaining in the Basis for Conclusions that unrealised losses on debt instruments are not an exception to the requirement proposed in paragraph 27A.

21 EFRAG agrees with the proposed amendments in paragraph 27A of IAS 12 as they add clarity to IAS 12 on how entities have to group deductible temporary differences when assessing their utilisation.

22 While IAS 12 requires taxes in the same entity and for the same tax jurisdiction to be presented net (under certain conditions), there is no explicit requirement within IAS 12 to separate capital and ordinary items, despite the fact that there are tax laws in some jurisdictions which limit the ability of a company to offset capital losses against ordinary income. This may be a reason why different companies have interpreted the requirements of IAS 12 differently. That is, some companies evaluate temporary differences for capital items separate from ordinary items. Other companies combine the capital and ordinary items when assessing whether or not to recognise a deferred tax asset. Depending on which approach is adopted, it impacts the net deferred tax assets and, consequently, the recognition criteria of whether a deferred tax asset can be recognised or not.

23 Furthermore, EFRAG has learnt from the due process followed by the IASB that diversity in practice arises in the particular case of deductible temporary differences related to unrealised losses on debt instruments measured at fair value. In effect, although incorrectly, some assess the utilisation of deductible temporary differences related to unrealised losses on debt instruments separately from other deferred tax assets. This is because they believe that deductible temporary differences relating to unrealised losses are unique and can be recognised without a future tax deduction. In other words, these temporary differences are expected to reverse through the passage of time without affecting future taxable profits and, therefore, supporters of this view do not require, for these particular deductible temporary differences, a reduction in future tax payments as a requisite for the recognition of the corresponding deferred tax asset.

24 Therefore, in order to avoid the misunderstandings from those who support the rationale explained in paragraph 23 above, EFRAG suggests explaining in the Basis for Conclusions that unrealised losses on debt instruments are not an exception to the requirement proposed in paragraph 27A. Otherwise, some constituents might still believe that unrealised losses on debt instruments are unique and that they can be recognised even without an expected future tax deduction because they should be subject to a separate assessment for utilisation. Should it not be clarified in the Basis for Conclusions of the proposed amendments, only the illustrative example 7 will provide an implicit answer to those who hold that view.

Question 5—Transition

The IASB proposes to require limited retrospective application of the proposed amendments for entities already applying IFRS. This is so that restatements of the opening retained earnings or other components of equity of the earliest comparative period presented should be allowed but not be required. Full retrospective application would be required for first-time adopters of IFRS.

Do you agree with the proposed amendment? Why or why not? If not, what alternative do you propose?

EFRAG's response:

EFRAG agrees with the proposed transition requirements. However, EFRAG believes that the wording of the proposed amendments, when referring to "limited retrospective application" of the requirements, is confusing and should be improved.

25 EFRAG agrees with the transition requirements proposed in the ED for first-time adopters of IFRS (no transition relief).

26 However, EFRAG believes that the wording of the proposed amendments for entities already applying IFRS, when referring to "limited retrospective application" of the requirements, is unclear. While we agree with some form of relief in the application of the requirements for entities already applying IFRS, we think that the wording should be improved.

Other issues identified

27 EFRAG believes that the illustrative example included as part of the non-mandatory part of the Standard (illustrative example 7) should be shorter. In our view, the focus should be on the main amendments and should not be excessive. Having such a detailed example might prevent the reader to understand the key facts. We think that our suggestion in question 3 of including an example illustrating paragraph 29(a)(i) would allow to shorten illustrative example 7 without losing relevant information.

28 EFRAG also notes that paragraphs IE41 to IE43 state that the changes in deferred taxes are allocated to profit and loss or other comprehensive income based on a reasonable prorata allocation (in accordance with paragraph 63 of IAS 12). Paragraph 63 of IAS 12 requires entities "to recognise current and deferred tax related to items that are recognised outside profit or loss based on a reasonable prorata allocation, or other method that achieves a more appropriate allocation in the circumstances". Therefore, we think that IE43 is not fully consistent with paragraph 63 of IAS 12. We suggest either removing this wording from paragraphs IE41 to IE43 or changing the wording of paragraph IE43 to align it with paragraph 63 of IAS 12.