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Deferred tax related to Assets and Liabilities arising from a Single Transaction (Amendments to IAS 12)

Cover Note

Objective

- 1 The objective of this session is to discuss and agree to recommend to the EFRAG Board, a draft endorsement advice and invitation to comment (the 'Amendments').

Preliminary comments

- 2 The Amendments introduce changes to IAS 12 *Income Taxes*.

Background

- 3 In 2018, the IFRS Interpretations Committee (IFRS IC) received a request to clarify the accounting for deferred tax under IAS 12 in circumstances when both an asset and a liability arises from a single transaction. Typical examples are the recognition of a lease (which involves recognising a lease asset and a lease liability), and a decommissioning provision (with the counter-entry recognised as part of the related asset). The request stated that the lease payments and decommissioning costs were deductible for tax purposes on a cash basis.
- 4 The IFRS IC observed that the issue is widespread and that entities apply IAS 12, in particular the initial recognition exception, in different ways to such transactions. The IFRS IC decided to ask the IASB to amend IAS 12 and restrict the application of the initial recognition exemption so that it would not apply to transactions that give rise to temporary differences of the same amount.
- 5 The IASB published the exposure draft ED/2019/5 *Deferred Tax related to Assets and Liabilities arising from a Single Transaction* (the 'ED') in July 2019.
- 6 EFRAG issued its comment letter ([here](#)) in response to the exposure draft on 14 November 2019. In its letter, EFRAG:
 - (a) supported the IASB's efforts to address the issue and help reduce diversity in practice in the accounting for deferred tax for such transactions.
 - (b) expressed its concern with the recognition 'cap' in paragraph 22A (b) of the ED and the complexity it adds to accounting in subsequent periods.
 - (c) considered the scope of the ED to be broader than leases and decommissioning obligations and suggested the IASB to consider applying the proposals only to lease transactions as it could address a significant part of the existing diversity, and at the same time limit and potentially avoid unintended consequences.

- (d) considered whether the gross approach under the proposed ED was the better solution to address the issue and noted advantages and disadvantages of the gross and net approach.
 - (e) supported the proposal to require entities to apply the amendments retrospectively with earlier application permitted. It also supported the optional transition relief in relation to the recoverability requirement for deferred tax asset.
 - (f) EFRAG considered that the proposals by adding an exception to an existing exemption in IAS 12, result in additional complexity to the application of the Standard. Indeed, the proposals highlighted broader concerns with how IAS was understood and applied in practice, particularly the initial recognition exception in IAS 12. EFRAG recommended the IASB to consider IAS 12 more broadly as part of its future workplan.
- 7 Appendix A provides a summary of some of above EFRAG's recommendations and how they were addressed by the IASB.

Amendments issued

- 8 The IASB issued the Amendments on 7 May 2021 which are effective from 1 January 2023, but entities can decide to apply them earlier.
- 9 The European Commission issued a letter requesting advice on the endorsement of the Amendments on 21 May 2021 (uploaded as paper 02-04). The letter does not identify specific additional issues to investigate.
- 10 A link to the IASB publication, on EFRAG's website, is provided under permission of the IASB and is only valid until the publication of the Amendments/Standard in the official journal. ([here](#)).

Draft endorsement advice

- 11 The proposed draft Endorsement Advice submitted to EFRAG TEG review suggests the following conclusions
- (a) EFRAG considers that the Amendments will bring improved financial reporting when compared to previous guidance. As such, their endorsement is conducive to the European public good in that improved financial reporting improves transparency and assists in the assessment of management stewardship.
 - (b) EFRAG has not identified that the Amendments could have any adverse effect to the European economy, including financial stability and economic growth.
 - (c) Furthermore, EFRAG has not identified any other factors that would mean endorsement of the Amendments is not conducive to the European public good.
 - (d) Having considered all relevant aspects, including the trade-off between the costs and benefits of implementing the Amendments, EFRAG assesses that endorsing the Amendments is conducive to the European public good.

Questions for EFRAG TEG

- 12 Do EFRAG TEG members have comments on the information contained in paragraphs 1 to 11, above and in Appendix A below?
- 13 Does EFRAG TEG agree to recommend the draft endorsement advice (contained in paper 02-02) and the invitation to comment (contained in paper 02-03) for consideration by the EFRAG Board?
- 14 Do EFRAG TEG members agree with a consultation period of Three months for the Draft Endorsement Advice?

Agenda Papers

- 15 In addition to this cover note, agenda papers for this session are:
 - (a) Agenda paper 02-02 – EFRAG’s draft letter to the European Commission regarding Deferred Tax Related to Assets and Liabilities arising from a Single Transaction (*Amendments to IAS 12*);
 - (b) Agenda paper 02-03 – Invitation to comment on EFRAG’s Assessment; and
 - (c) Agenda paper 02-04 – Letter from the European Commission requesting endorsement advice– for background only.

Appendix A: Follow-up on EFRAG’s CL recommendations

| EFRAG views and recommendations | Final Amendments |
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| Recognition cap | |
| <p>EFRAG expressed its concern with the recognition ‘cap’ in paragraph 22A of the ED and the complexity it adds to accounting in subsequent periods.</p> <p>EFRAG disagreed 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. Contrary to the general principle in IAS 12 that all DTL are to be recognized. However, it considered that the ‘cap’ was a pragmatic solution to avoid recognising a day one loss and to meet the objective of the recognition exemption (par. 22 (c)).</p> | <p>The IASB has removed paragraph 22 A of the ED, containing the capping proposal, based on the following reasons:</p> <ol style="list-style-type: none"> 1) Applying the recognition exemption to a deferred tax liability only because an entity is unable to recognise a corresponding deferred tax asset applying the recoverability requirement would be inconsistent with how the IAS 12 initial recognition exemption is applied in other situations. 2) Removing the capping proposal would significantly reduce the complexity of applying the Amendments while still achieving their objective (reduce diversity and align the accounting with the general principles of IAS 12). By removing the capping proposal, the IASB would: <ul style="list-style-type: none"> - not require an entity to assess of the recoverability requirement on initial recognition of each applicable transaction to determine the extent to which a deferred tax liability can be recognised. - Simplify the accounting. <p>The amendments might result in an entity recognising unequal amounts of deferred tax on initial recognition of a transaction, recognising any difference in P/L. The IASB concluded that this accounting would appropriately reflects the entity’s expectation that it will be unable to benefit fully from the tax deductions available when it settles the liability, but that it is nonetheless required to make future tax payments as it recovers the asset.</p> |
| Net vs Gross approach | |
| <p>EFRAG considered whether the gross approach under the proposed ED was the better solution to address the issue and noted advantages and disadvantages of the gross and net approach.</p> | <p>The Amendments keep the 'gross approach'.</p> <p>Despite acknowledging that the net approach would address many of the concerns raised by respondents, including EFRAG, (it would remove the complexities from the capping proposal and would result in no DTA/DTL being recognised on initial recognition) the IASB considered that:</p> <ol style="list-style-type: none"> 1) The approach could be complex and costly to apply depending on the systems and processes entities have in place for leases and decommissioning obligations. 2) It would introduce exceptions to the general principles in IAS 12. |
| Scope | |

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| <p>EFRAG considers the scope of the ED to be broader than leases and decommissioning obligations and other transactions are likely to fall within its remit. There could be unintended consequences. One way forward could be for the IASB to consider applying the proposals only to lease transactions</p> | <p>The Amendments keep the initial scope</p> <p>The IASB considers that the principle underlying the proposed amendments—that the recognition exemption is unnecessary for transactions which give rise to equal and offsetting temporary differences—is applicable regardless of the nature of the transaction.</p> <p>Some respondents provided examples of other transactions that might be within the scope of the proposed amendments, but did not explain why the proposals should not apply to such transactions. The IASB agrees with respondents that the proposed amendments could apply to those transactions, but see no reason that they should not.</p> |
| <p>Transition</p> | |
| <p>EFRAG supported the proposal to require entities to apply the amendments retrospectively with earlier application permitted. It also supported 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. Retrospective application for leases and decommissioning obligations assessing the recoverability requirement could in some cases be impracticable or result in undue costs</p> | <p>As a consequence of removing the capping proposal, the IASB has modified the transition requirements.</p> <p>The IASB considers that removing the capping proposal, makes the transition relief proposed no longer be necessary as entities would no longer be required to assess recoverability on initial recognition of each transaction to determine the extent to which a deferred tax liability can be recognised.</p> <p>The IASB decided to require entities to apply the amendments for the first time by recognising deferred tax for all temporary differences related to leases and decommissioning obligations at the beginning of the earliest comparative period presented. It concluded that these requirements appropriately balance expected benefits and costs. The IASB concluded that its transition approach would therefore make the amendments easier and less costly to apply than a full retrospective approach, while still achieving their objective. Such an approach also avoids any uncertainty about how the amendments interact with the transition requirements in IFRS 16.</p> <p>The IASB also decided to require entities to apply the amendments prospectively to transactions other than leases and decommissioning obligations. If the amendments were to be applied retrospectively, identifying whether such transactions are in the scope of the amendments could be costly and complex.</p> |