

# Deferred Tax related to Assets and Liabilities arising from a Single Transaction

## Proposals to amend IAS 12 *Income Taxes*



The International Accounting Standards Board (Board) proposes to amend IAS 12. The proposed amendments would clarify the accounting for deferred tax on particular transactions, such as leases and decommissioning obligations.

Gary Kabureck, a member of the Board, explains what the Board is proposing and why.

### What is deferred tax?

**Deferred tax** represents amounts of income tax payable or recoverable in the future.

### How do companies report deferred tax?

A company recognises deferred tax when recovering an asset or settling a liability in the future will have tax consequences (that is, will affect the amount of tax the company will pay).

Such tax consequences result from differences between the amount of assets and liabilities for accounting purposes (their **carrying amount**) and the amount for tax purposes (their **tax base**).<sup>1</sup> These differences are known as **temporary differences** because they will eventually reverse when the company recovers the asset or settles the liability.

The reversal of temporary differences will either increase or reduce taxable profit. A company recognises:

- (a) a **deferred tax asset** for temporary differences that will reduce taxable profit (deductible temporary differences).
- (b) a **deferred tax liability** for temporary differences that will increase taxable profit (taxable temporary differences).

Example 1 illustrates these concepts.

#### Example 1—deferred tax asset related to a provision

Applying IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, a company recognises a provision of CU100 regarding a legal dispute.<sup>2</sup> The company receives a deduction for tax purposes only when it makes payments to settle the legal dispute. The company determines that the tax base of the provision is nil (carrying amount of CU100 less the amount that will be deductible for tax purposes, also CU100).

There is a deductible temporary difference of CU100 between the carrying amount of the provision (CU100) and its tax base (nil). This deductible temporary difference will reverse when the company makes payments to settle the provision and receives the tax deductions. These tax deductions will reduce the company's taxable profit in future periods. Accordingly, the company recognises a deferred tax asset.

<sup>1</sup> The tax base of an asset is the amount that will be deductible for tax purposes; the tax base of a liability is its carrying amount, less any amounts that will be deductible for tax purposes.

<sup>2</sup> In this document, monetary units are denominated in 'currency units' (CU).

## How do these requirements apply to leases?

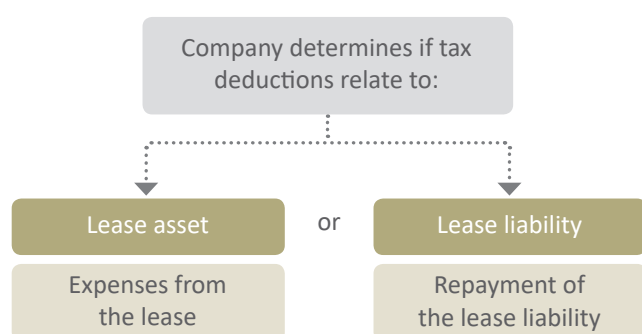
IFRS 16 *Leases* requires a company to recognise a right-of-use asset (lease asset) and a lease liability for leases.<sup>3</sup> Over the lease term, the company recognises depreciation and interest expense as it uses the lease asset and settles the lease liability.

However, many tax authorities provide tax deductions only when a company makes lease payments (not when a company recognises depreciation and interest expense). In these circumstances, a company needs to apply judgement in determining whether those tax deductions relate to the lease asset or to the lease liability. Depending on the applicable tax law, tax deductions may relate to either:

- the lease asset—because they relate to expenses from the lease (depreciation and interest expense); or
- the lease liability—because they relate to the repayment of the lease liability and interest expense.

Diagram 1 illustrates these situations.

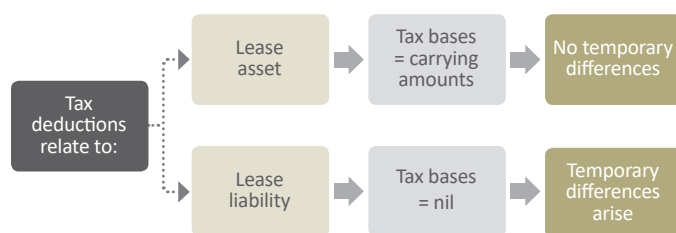
Diagram 1—Allocating tax deductions



When tax deductions relate to the lease asset, no temporary differences arise when a company initially recognises the lease asset and lease liability.

However, when tax deductions relate to the lease liability, temporary differences arise on initial recognition. Diagram 2 illustrates these outcomes.

Diagram 2—Outcomes of allocating tax deductions



A company would recognise deferred tax for such temporary differences applying the general principle in IAS 12. However, IAS 12 prohibits a company from doing so if the **recognition exemption** applies.

## What is the recognition exemption?

The recognition exemption prohibits a company from recognising deferred tax when it initially recognises an asset or liability in particular circumstances. One of these circumstances is the recognition of a transaction that affects neither accounting profit nor taxable profit (and is not a business combination).

## Does the recognition exemption apply to leases?

The Board is aware that views differ on whether the recognition exemption applies to temporary differences arising when a company initially recognises a lease. When the recognition exemption applies, a company does not recognise deferred tax, either on initial recognition of the lease or subsequently throughout the lease term.

<sup>3</sup> In this document, we use leases as an example, but the explanations apply equally to decommissioning obligations and any other transactions that give rise to both an asset and a liability.

## What are the consequences of not recognising deferred tax?

When a company does not recognise deferred tax, the tax expense for a period will reflect tax deductions as and when they become available for tax purposes (that is, when lease payments are made), rather than as the company uses the lease asset and settles the lease liability.

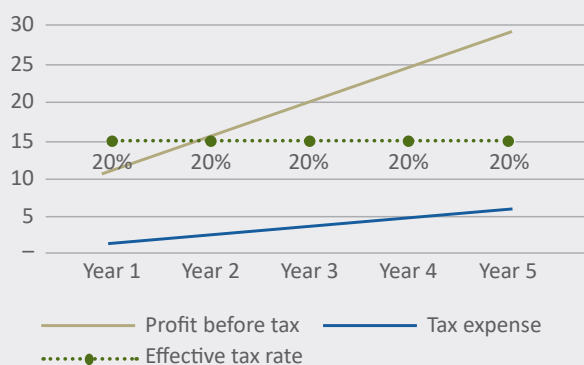
Example 2 illustrates the effects of recognising (or not recognising) deferred tax on a lease.

### Example 2—effects of recognising (or not recognising) deferred tax on a lease

Consider the following simplified scenario:

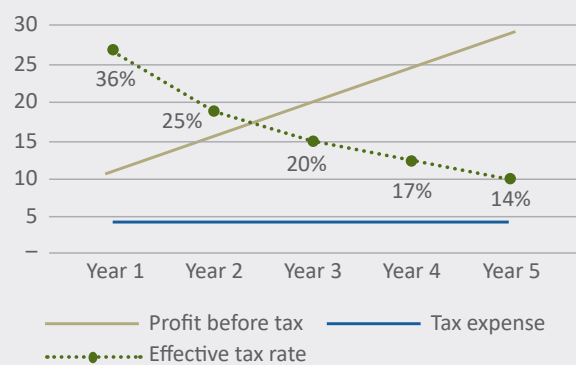
- A company leases a building for five years and depreciates the lease asset on a straight-line basis over the five-year lease term.
- Lease payments of CU100 are payable at the end of each year and are deductible for tax purposes when paid.
- The company recognises revenue of CU120 each year and has no other expenses.
- The discount rate applied to the lease is 5% and the company is subject to a tax rate of 20%.

Graph 1—Recognising deferred tax



Graph 1 illustrates the outcome of recognising deferred tax over the lease term. This would be the outcome when tax deductions relate to the lease asset. The graph shows that the tax expense recognised over time is proportional to profit before tax, resulting in a constant effective tax rate over the period. The company reflects the tax effects of the lease in profit or loss as it uses the lease asset and recognises interest on the lease liability.

Graph 2—Not recognising deferred tax



Graph 2 illustrates the outcome of not recognising deferred tax. This would be the outcome when tax deductions relate to the lease liability and the recognition exemption applies. The graph shows that the tax expense recognised is constant over time, resulting in different effective tax rates in each year. The company reflects the tax effects of the lease in profit or loss as the tax deductions become available for tax purposes (that is, when lease payments are made).

*(The appendix sets out the detailed calculations used in this example.)*

## What is the Board proposing?

Example 2 above illustrates that recognising (or not recognising) deferred tax may have significant effects for companies. The Board also noted the recognition exemption is not needed for transactions that give rise to both an asset and a liability. Consequently, the Board is proposing amendments to require a company to recognise deferred tax for temporary differences that arise on such transactions. The proposed amendments would do so by narrowing the scope of the recognition exemption.

### Reasons for proposing to amend IAS 12

- **Faithful representation**—the proposed amendments would align the accounting for deferred tax with the general principle in IAS 12, resulting in a company recognising the tax effects of a lease as it uses the lease asset and settles the lease liability.
- **Reduction of diversity in practice**—views differ on whether a company is required to apply the recognition exemption when it accounts for leases. The proposed amendments would clarify the accounting in this respect.
- **Narrow scope**—the proposed amendments would be narrow in scope thereby reducing the risks of unintended consequences that could arise from more substantial changes to IAS 12.

## What are the implications?

Companies that do not currently recognise deferred tax for transactions affected by the proposals would be required to do so.

Companies that already recognise deferred tax for transactions within the scope of the proposals would be unaffected.

### Questions and answers

#### 1. Would the proposals apply to all leases and decommissioning obligations?

No. The proposed amendments would apply only when tax deductions relate to the lease liability or decommissioning liability. They would have no effect when tax deductions relate to the lease asset or the item of property, plant and equipment (in the case of a decommissioning obligation).

#### 2. Would advance lease payments and initial direct costs be affected by the proposals?

No. A company would apply the existing requirements in IAS 12 to any taxable temporary difference arising from making advance lease payments or paying initial direct costs.

#### 3. Are there any specific transition requirements?

Yes. The Board is proposing 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.

## What happens next?

The Board has set out its proposals in Exposure Draft *Deferred Tax related to Assets and Liabilities arising from a Single Transaction*.

We welcome comments from all interested parties. We will consider all comments received by 14 November 2019 in deciding whether and how to finalise the amendments to IAS 12.

You can submit comments on the [‘Open for Comment documents’](#) page of the IFRS Foundation website.

## Further information

Visit the [project page](#) on the IFRS Foundation website—Deferred Tax related to Assets and Liabilities arising from a Single Transaction—to:

- download a copy of the Exposure Draft; and
- register to receive project updates.

## Get in touch

Contact Gustavo Olinda at [golinda@ifrs.org](mailto:golinda@ifrs.org).

Follow [@IFRSFoundation](#) on Twitter to keep up with changes in the world of IFRS Standards.

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## APPENDIX—Calculations supporting Example 2

This appendix illustrates the calculations supporting Example 2 on page 3.

### 1. Fact pattern

In the example, a company leases a building for five years and depreciates the lease asset on a straight-line basis over the five-year lease term. Lease payments of CU100 are payable at the end of each year and are deductible for tax purposes when paid. The company recognises revenue of CU120 each year and has no other expenses. The discount rate applied to the lease is 5% and the company is subject to a tax rate of 20%.

### 2. Calculations in accounting for the lease and current tax

#### 2.1 Carrying amounts of lease asset and lease liability

##### Initial measurement

The company initially measures the lease liability and the cost of the lease asset at CU435, which is the present value of the annual lease payments of CU100 discounted at 5%.

##### Lease asset

The company subsequently measures the lease asset by applying the cost model. Each year the company calculates an annual depreciation charge of CU87 ( $CU435 \div 5$ ) and deducts that amount from the carrying amount of the lease asset.

	Opening carrying amount	Depreciation	Closing carrying amount
Year 1	435	(87)	348
Year 2	348	(87)	261
Year 3	261	(87)	174
Year 4	174	(87)	87
Year 5	87	(87)	–
<b>Total</b>		<b>(435)</b>	

##### Lease liability

Each year the company calculates interest by applying the discount rate (5%) to the carrying amount of the lease liability. The company adds that interest to the carrying amount of the lease liability. In addition, the company deducts the payment of CU100 made at the end of each year.

	Opening carrying amount	Interest accrued	Payments	Closing carrying amount
Year 1	435	22	(100)	357
Year 2	357	17	(100)	274
Year 3	274	13	(100)	187
Year 4	187	9	(100)	96
Year 5	96	4	(100)	–
<b>Total</b>		<b>65</b>	<b>(500)</b>	

## 2.2 Current tax calculation

The company calculates current tax payable by applying the applicable tax rate of 20% to the taxable profit of CU20. The taxable profit in each year is revenue of CU120 less tax deductions of CU100.

	Year 1	Year 2	Year 3	Year 4	Year 5
Revenue	120	120	120	120	120
Tax deduction	(100)	(100)	(100)	(100)	(100)
Taxable profit	20	20	20	20	20
Current tax expense (@20%)	4	4	4	4	4

## 3. Scenario A—tax deductions relate to the lease asset

The calculations in section 3.1 assume tax deductions relate to the lease asset.

### Reminder

**Temporary differences** are differences between the carrying amount and the tax base of an asset or a liability. The **tax base of an asset** is the amount that will be deductible for tax purposes; the **tax base of a liability** is its carrying amount, less any amounts that will be deductible for tax purposes.

### 3.1 Temporary differences and deferred tax

#### Lease asset

The deductible temporary difference related to the lease asset is the difference between its carrying amount (see the calculation in section 2.1) and its tax base. The tax base of the lease asset is the amount on initial recognition of CU435, reduced each year by the tax deduction received that relates to the lease asset. The tax deduction related to the lease asset is the total tax deduction received in each year (CU100) less the portion of that tax deduction related to interest expense (see note below). For example, in year one, the tax base of the asset is reduced from CU435 to CU357 due to the receipt of a deduction of CU78. This deduction is calculated as the total deduction of CU100 less an amount of CU22 related to interest expense.

	Carrying amount	Tax base	Deductible temporary difference	Deferred tax asset
Initial recognition	435	435	—	—
Year 1	348	357	9	1.8
Year 2	261	274	13	2.6
Year 3	174	187	13	2.6
Year 4	87	96	9	1.8
Year 5	—	—	—	—

**Note**—for the purposes of this example, we assume tax deductions received in each period are attributed first to interest expense accrued and then to depreciation.

#### Lease liability

There is no temporary difference in respect of the lease liability in each year. The tax base of the lease liability equals its carrying amount (see the calculation in section 2.1) because the company will receive no tax deductions for the settlement of the lease liability.

### 3.2 Statement of profit or loss

This statement of profit or loss includes the amounts of depreciation, interest and current tax expense calculated in section 2. It also includes revenue of CU120, and the effect of changes in the amounts of deferred tax in each year (calculated in section 3.1). As illustrated in Graph 1 on page 3, the resulting effective tax rate (tax expense over profit before tax) is a constant rate of 20%, which is equal to the applicable tax rate.

	Year 1	Year 2	Year 3	Year 4	Year 5
Revenue	120	120	120	120	120
Depreciation expense	(87)	(87)	(87)	(87)	(87)
Interest expense	(22)	(17)	(13)	(9)	(4)
<i>Profit before tax</i>	<i>11</i>	<i>16</i>	<i>20</i>	<i>24</i>	<i>29</i>
Current tax expense	4	4	4	4	4
Deferred tax expense/(income)	(1.8)	(0.8)	–	0.8	1.8
<i>Tax expense</i>	<i>2.2</i>	<i>3.2</i>	<i>4.0</i>	<i>4.8</i>	<i>5.8</i>
<i>Profit after tax</i>	<i>8.8</i>	<i>12.8</i>	<i>16.0</i>	<i>19.2</i>	<i>23.2</i>
<b>Effective tax rate</b> <b>(Tax expense/Profit before tax)</b>	<b>20%</b>	<b>20%</b>	<b>20%</b>	<b>20%</b>	<b>20%</b>

### 4. Scenario B—tax deductions relate to the lease liability and the recognition exemption applies

The calculations in 4.1 assume tax deductions relate to the lease liability and the recognition exemption applies to any temporary differences arising from the initial recognition of the lease.

#### 4.1 Temporary differences

##### Lease asset

There is a taxable temporary difference in each year equal to the carrying amount of the lease asset. The tax base of the lease asset is nil—the company will not receive tax deductions for the use of the lease asset. However, the company does not recognise a deferred tax liability because the recognition exemption applies.

	Carrying amount	Tax base	Taxable temporary difference	Deferred tax liability
Initial recognition	435	–	435	–
Year 1	348	–	348	–
Year 2	261	–	261	–
Year 3	174	–	174	–
Year 4	87	–	87	–
Year 5	–	–	–	–



### Lease liability

There is a deductible temporary difference in each year equal to the carrying amount of the lease liability. The tax base of the lease liability is nil—the carrying amount of the liability will be fully deductible when settled. However, the company does not recognise a deferred tax asset because the recognition exemption applies.

	Carrying amount	Tax base	Deductible temporary difference	Deferred tax asset
Initial recognition	433	–	433	–
Year 1	355	–	355	–
Year 2	272	–	272	–
Year 3	186	–	186	–
Year 4	95	–	95	–
Year 5	–	–	–	–

### 4.2 Statement of profit or loss

This statement of profit or loss is similar to the one for Scenario A, except that it does not include deferred tax income or expense. As illustrated in Graph 2 on page 3, the tax expense is constant, resulting in different effective tax rates in each year.

	Year 1	Year 2	Year 3	Year 4	Year 5
Revenue	120	120	120	120	120
Depreciation expense	(87)	(87)	(87)	(87)	(87)
Interest expense	(22)	(17)	(13)	(9)	(4)
<i>Profit before tax</i>	<i>11</i>	<i>16</i>	<i>20</i>	<i>24</i>	<i>29</i>
Current tax expense	4	4	4	4	4
Deferred tax expense/(income)	–	–	–	–	–
<i>Tax expense</i>	<i>4</i>	<i>4</i>	<i>4</i>	<i>4</i>	<i>4</i>
<i>Profit after tax</i>	<i>7</i>	<i>12</i>	<i>16</i>	<i>20</i>	<i>25</i>
<b>Effective tax rate (Tax expense/Profit before tax)</b>	<b>36%</b>	<b>25%</b>	<b>20%</b>	<b>17%</b>	<b>14%</b>

The tables above illustrate that no deferred tax is recognised for the temporary differences because the recognition exemption applies. If, however, the recognition exemption had not applied, the company would recognise a deferred tax asset and deferred tax liability. In that case, the recognition of deferred tax would have had the same net effect in profit or loss as in Scenario A.

The proposed amendments affect Scenario B, not Scenario A. Applying the proposed amendments, the company would recognise a deferred tax asset and deferred tax liability for the temporary differences that arise on initial recognition and subsequently.