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14 November 2019

Dear Sir

Exposure Draft ED/2019/5: Deferred Tax related to Assets and Liabilities arising from a Single Transaction

We are pleased to comment on the above Exposure Draft (the ED). Following consultation with the BDO network[1], this letter summarises views of member firms that provided comments on the ED.

We are supportive of the amendments proposed by the IASB as they clarify the intention of the Board and have the potential to reduce diversity in practice, particularly with regard to the deferred tax implications of IFRS 16 which are widespread. However, we believe that the proposed amendments should be modified in order to make them operational and to eliminate potentially unintended consequences.

Our responses to the questions in the ED are set out in the attached Appendix A.

We hope that you will find our comments and observations helpful. If you would like to discuss any of them, please contact me at +44 (0)20 7893 3300 or by email at abuchanan@bdoifra.com.

Yours faithfully

Andrew Buchanan

Andrew Buchanan

Global Head of IFRS

[1] Service provision within the international BDO network of independent member firms ('the BDO network') in connection with IFRS (comprising International Financial Reporting Standards, International Accounting Standards, and Interpretations developed by the IFRS Interpretations Committee and the former Standing Interpretations Committee), and other documents, as issued by the International Accounting Standards Board is provided by BDO IFR Advisory Limited, a UK registered company limited by guarantee. Service provision within the BDO network is coordinated by Brussels Worldwide Services BVBA, a limited liability company incorporated in Belgium. Each of BDO International Limited (the governing entity of the BDO network), Brussels Worldwide Services BVBA, BDO IFR Advisory Limited and the member firms is a separate legal entity and has no liability for another such entity's acts or omissions. Nothing in the arrangements or rules of the BDO network shall constitute or imply an agency relationship or a partnership between BDO International Limited, Brussels Worldwide Services BVBA, BDO IFR Advisory Limited and/or the member firms of the BDO network.
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Appendix A

Question 1 - Do you agree with the Board's proposal to amend IAS 12 in the manner described in the Exposure Draft? If not, why not, and what do you recommend instead?

We agree with the Board's intention to amend IAS 12 to clarify the scope of the initial recognition exemption. IFRS 16 has introduced significant amounts of assets and liabilities that may otherwise be interpreted to be within the scope of the initial recognition exemption, when such a treatment of the associated deferred tax consequences would not faithfully represent the underlying economics.

We have two concerns relating to the drafting of the proposed amendments. The first relates to potential unintended consequences arising from how the proposed amendments have been drafted. The second relates to an operational complexity arising from the requirements of the proposed paragraph 22A(a). Our concerns are described in the following two sections.

Aside from these concerns, we also believe that illustrative examples should be added to IAS 12 that demonstrate how the proposed amendments function. We acknowledge that the IASB issued an 'In Brief' document that explains the rationale for the amendments and illustrative examples, however, including further illustrative examples in the body of the standard itself are more likely to be used. We also believe that as time elapses, documentation outside of the standard itself would be less likely to be used and/or accessible.

Interaction between IAS 12.15(b)(iii) and IAS 12.22(c)

As proposed by the exposure draft, IAS 12.15(b)(iii) introduces an additional criterion to be satisfied before the initial recognition exemption would apply and therefore no deferred tax would be recognised at initial recognition or subsequently. The proposed amendment states:

> '(iii) at the time of the transaction, does not give rise to equal amounts of taxable and deductible temporary differences (except as described in paragraph 22A).'

IAS 12.22(c), as proposed, states (emphasis added):

> '(c) if the transaction is not a business combination, and affects neither accounting profit nor taxable profit, and does not result in the recognition of equal amounts of deferred tax assets and liabilities, an entity would, in the absence of the exemption provided by paragraphs 15 and 24, recognise the resulting deferred tax liability or asset and adjust the carrying amount of the asset or liability by the same amount. ...'

The criterion established in IAS 12.15(b)(iii) notes that it is dependent on the absence of equal amounts of taxable and deductible temporary differences, whereas IAS 12.22(c) is drafted in the context of the absence of equal amounts of deferred tax asset and liabilities. In many circumstances, equal amounts of taxable and deductible temporary differences would give rise to equal amounts of deferred tax liabilities and assets, meaning this difference between IAS 12.15(b)(iii) and IAS 12.22(c) would not be substantive. However, this will not always be the case.

Consider the following example:

Entity A leases a piece of machinery from a lessor. The right-of-use asset and lease liability are CU 1,000 as at the commencement date of the lease. The corporate tax rate is 20%, however, the government is providing for a 'super-deduction' as the lessee makes lease payments. The deduction is equal to 130% of the lease payment made (e.g. a CU 50 lease payment would provide for a CU 65 deduction for tax purposes).

In this fact pattern, the taxable and deductible temporary differences are equal (CU 1,000), but the amounts of the related deferred tax asset and liability would not be equal. The deferred tax asset would be CU 260 (CU 1,000 * 20% tax rate * 1.3 'super-deduction' gross up), while the deferred tax liability would be CU 200 (CU 1,000 * 20 tax rate).

Since IAS 12.15(b)(iii) requires that, for the initial recognition exemption to apply, the transaction must not give rise to equal amounts of taxable and deductible temporary differences, the above noted scenario would not qualify for the initial recognition exemption and deferred tax would be recognised as calculated above. However, this appears to contradict the intention of the initial recognition exemption as articulated in IAS 12.22(c), since this would result in the initial carrying amounts of the recognised lease assets and liabilities being affected by the initial recognition of deferred tax.

We suggest that the proposed amendment to IAS 12.15(b) be modified to more clearly articulate the principle in IAS 12.22(c). We believe this could be accomplished by adding an additional criterion in IAS 12.15(b), which may be inserted as subparagraph (iv):

'at the time of the transaction, gives rise to equal amounts of temporary differences, which are subject to different tax rates.'

We believe that some interpret this 'super-deduction' as affecting the tax base rather than a difference in tax rate. One of the reasons we have proposed the addition of subparagraph (iv) is that this resolves this difference in interpretation and results in the initial recognition exemption applying regardless of this interpretation, which we believe is the appropriate conclusion.

Paragraph (iv) would be an 'or' analysis between (iii) and (iv), meaning if either of those two criteria are satisfied, then the initial recognition exemption would apply. This is because subparagraphs (iii) and (iv) would be mutually exclusive; only one of the two criteria could be satisfied by one fact pattern, however, we believe either case should result in the initial recognition exemption being applied.

This additional criterion would ensure that the initial recognition exemption would still apply in the scenario discussed above, where the temporary differences are technically equal, but would not give rise to equal amounts of deferred tax assets and liabilities.

Additionally, an illustrative example would also clearly illustrate the intentions of the proposed amendments.

Probability of Sufficient Taxable Profit to Realise Deferred Tax Assets

The proposed paragraph IAS 12.22A(a) requires that, when the initial recognition exemption does not apply to a transaction, the amount of a deferred tax asset is only recognised to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised. IAS 12.22A(b) then requires that the amount of a deferred tax liability arising from the same transaction be limited to the amount of the deferred tax asset recognised in accordance with IAS 12.22A(a).

We agree with the principle in IAS 12 that deferred tax assets should only be recognised to the extent that they will be recoverable in the future. However, we are concerned that IAS 12.22A(a) and (b) are not operationally realistic in the context of other requirements in IAS 12 for the recognition of deferred tax assets, and may be difficult to apply in practice. The assessment of whether the initial recognition exemption applies occurs at a point in time (i.e. the initial recognition of a lease or the point in time in which an entity becomes party to a decommissioning obligation in the scope of IAS 37). If it is determined that the initial recognition exemption does not apply (i.e. deferred tax assets and liabilities should be recognised), then having to determine whether a potential deferred tax asset meets the recognition criteria in IAS 12 based on an assessment of future taxable profits creates significant operational complexity. This is because the proposed standard is unclear as to how this 'point in time' assessment that occurs at initial recognition on a transaction by transaction basis interacts with the overriding requirement to assess for the recoverability of deferred tax assets (IAS 12.24).

Currently, most entities apply IAS 12.24 by computing deferred tax and then preparing an overall assessment of future taxable profit and the reversal of taxable temporary differences in order to determine the extent to which they should recognise deferred tax assets. This is typically done as at a financial reporting period end (e.g. 31 December for a calendar year-end entity).

Under the proposed amendments, entities may be required to analyse subsets of deductible temporary differences (or temporary differences arising from individual transactions) rather than an overall assessment of all deductible temporary differences together in situations where the expected timing of their reversal differs. This is because the proposed amendments are unclear as to how these proposed and existing requirements (IAS 12.22A(a) and IAS 12.24) interact. For example, once an assessment is done under IAS 12.22A(a) relating to the initial recognition of an asset/liability, it is unclear how the ongoing assessment of the recoverability of those deferred tax assets interact with IAS 12.24's requirements.

In some cases, in the context of a stand-alone transaction, the application of IAS 12.22A(a) may be simple. For example, as noted in BC22 of the exposure draft, the pattern of reversal of taxable and deductible temporary differences might be similar for leases, meaning the determination that deferred tax assets relating to that lease may be recoverable by virtue of the associated deferred tax liability reversing over a similar period of time.

However, when the timing of reversal differs for the deductible and taxable temporary differences (e.g. a decommissioning liability) or an entity has deferred tax assets that are already unrecognised due to the requirements of IAS 12.24, the way in which the proposed amendments would be applied becomes unclear.

For example, assume an entity had CU 1,500 of deferred tax assets related to unutilised tax losses carried forward that were unrecognised since they did not satisfy the requirements of IAS 12.24. The entity then enters into a new lease agreement that would give rise to equal and off-setting deferred tax assets and liabilities of CU 200. The entity would be required to apply IAS 12.22A(a) to determine whether the deferred tax asset relating to the deductible temporary difference should be recognised, and then IAS 12.22A(b) to determine if the corresponding deferred tax liability should be recognised as well. We believe it is unclear how IAS 12.22A(a) should be applied in this instance; should the deductible temporary difference arising from the lease be linked to the corresponding lease liability for the purposes of recoverability, or should it not?

This is because the existing 'notional' (i.e. unrecognised) deferred tax asset of CU 1,500 relating to tax losses would also be available to off-set the unwinding of a deferred tax liability relating to the newly recognised lease, so we believe it is unclear how the deferred tax asset arising from the application of IAS 12.22A(a) should be determined. Would the amended standard require the recoverability of the deferred asset that is 'linked' to the deferred tax liability to be assessed first before considering how other unrecognised deferred tax assets might justify the valuation of the deferred tax asset? We believe the Board should clarify the ordering of these requirements.