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ED/2014/3 Recognition of Deferred Tax Assets for Unrealised Losses- Proposed amendments to IAS 12

Grant Thornton International Ltd is pleased to comment on the International Accounting Standards Board's (the Board) *ED/2014/3 Recognition of Deferred Tax Assets for Unrealised Losses - Proposed amendments to IAS 12* (the ED). We have considered the ED, as well as the accompanying draft Basis for Conclusions.

We agree with the analysis underlying the ED's proposed amendments and the conclusions reached in the proposed Illustrative Example.

We also note however that the proposed amendments are detailed and extensive but address only a narrow fact pattern. We believe that the evident diversity in practice in this fact pattern reflects a lack of clarity in some of the basic concepts and definitions in IAS 12 'Income Taxes' (IAS 12). This lack of clarity gives rise to questions of interpretation in other fact patterns involving accounting gains and losses that are not recognised for tax purposes. We would prefer the amendments to have a broader and more principle-based focus. That said, we acknowledge that the Board has initiated a research project on income taxes and that this may be a more suitable vehicle to consider the need for broader clarifications.

Our responses to the ED's Invitation to Comment are set out in the Appendix.

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If you have any questions on our response, or wish us to amplify our comments, please contact our Global Head of IFRS, Andrew Watchman (andrew.watchman@gti.gt.com or telephone + 44 207 391 9510).

Yours sincerely,

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Responses to Invitation to Comment questions

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?

We agree that a deductible temporary difference exists in the circumstances described but we think the proposed amendment could explain this more clearly.

In our view a temporary difference exists because the holder of the debt instrument in concern has recognised an accounting loss (the negative fair value movement attributed to an increase in the risk-free rate) that is expected to reverse as it recovers the asset in the expected manner. These future accounting gains will not be recognised for tax purposes. This will lead to adjustments over the life of the asset that will decrease future taxable profits relative to future accounting comprehensive income.

This points to a broader lack of clarity regarding IAS 12's definition of deductible temporary differences ("temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled"). This definition is difficult to relate to the transaction in concern, which involves accounting gains and losses that are not recognised for tax purposes. We suggest that the definitions of temporary differences, or the supporting guidance, should directly address accounting gains and losses that are not recognised in the tax return but will lead to future differences between accounting and taxable profit (loss). It should be made clearer that such adjustments should be considered to be "amounts that are deductible". This is relevant to many other fact patterns in addition to those considered in the ED.

Similarly, IAS 12's examples illustrating the definition of "tax base" (paragraphs 7 and 8) refer to situations in which repaying a loan has no tax consequences. In those examples the tax base is stated to equal the carrying amount of the loan. We suggest that these references to "no tax consequences" merit clarification. In our view there are tax consequences if recovery or settlement of the carrying amount will lead to future differences between accounting and taxable profit (loss).

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?

We agree with the technical substance of the proposed amendment but are not convinced it is necessary or helpful.

We agree that forecasts of future taxable profits are not constrained by, or limited to, the carrying amounts of recognised assets. We also agree with the discussion in BC12 to the effect that determining temporary differences, and estimating probable future taxable profit against which deductible temporary differences are assessed for utilisation, are separate steps. However, we suggest these matters are already sufficiently clear.

If the Board decides to provide guidance in this area, we suggest the following detailed matters should be reconsidered:

- it is not entirely evident that assuming recovery of an asset for more than its carrying amount is actually relevant to the fact pattern in concern. In some cases (for example, selling an item of inventory at a profit) it is clear that a transaction involves recovery for more than carrying amount. Making such an assumption is usually implicit in estimating future taxable profits. In the fact pattern in concern, however, the purported recovery in excess of carrying amount simply reflects the time value of money and arises from the unwinding of the increase in the discount rate. The unwinding, if it occurs, will create an accounting gain that will not be taxable. The issue therefore seems to be whether it is appropriate to assume that the contractual cash flows will be collected in full if fair value has declined to below cost
- the wording of proposed paragraph 29A suggests that IAS 12's probability criterion is assessed at the level of the recovery of individual assets. We doubt this is a prevalent or practical approach. We believe instead that entities generally assess future levels of taxable profits, and their probability, at a higher level of aggregation taking into account all relevant facts and circumstances.

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?

We agree that an entity's estimate of future taxable profit excludes tax deductions resulting from the reversal of the deductible temporary differences that are being assessed for recoverability. However, the proposed amendments to paragraph 29 provide only partial guidance on the relationship between temporary differences and estimates of future taxable profits.

For example, estimate of future taxable profits should presumably also:

- exclude taxable income arising from taxable temporary differences that have already been taken into account in the paragraph 28 earlier step
- include the reversal of temporary differences that are not recognised in accordance with paragraphs 15 and 25.

If the Board believes that clarification is desirable we would prefer this to address the relationship between temporary differences and estimates of future taxable profits more comprehensively. However, we would also question whether further guidance in this area would have a significant practical effect. We say this because estimating future taxable profit and assessing probability are highly judgemental matters that involve significant estimation uncertainty. Adding piecemeal guidance on how to incorporate specific matters into these estimates suggests a degree of precision that may be artificial.

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?

We agree for the reasons set out in BC19-BC21.

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?

We agree with the proposed transition approach subject to the following clarification.

The proposed transition provisions are silent on the required approach if an entity takes advantage of the relief not to restate the opening retained earnings or other components of equity of the earliest comparative period presented. Retrospective application requires some kind of cumulative catch-up adjustment to opening equity at that date. We therefore assume that the relief is intended to permit entities to credit or charge the catch-up adjustment to a single component of equity (eg retained earnings) instead of allocating it among components (retained earnings, OCI and other components if applicable). We suggest this should be explained explicitly.

Other comments and drafting suggestions

We also have the following minor drafting comments and suggestions.

26(d) The proposed new example illustrating paragraph 26(d) includes a statement that the tax base of the debt instrument equals its original cost. If this is the case then it follows (from paragraph 11 of IAS 12) that a deductible temporary difference exists. The statement regarding the amount of the tax base therefore makes much of the rest of the example redundant. The proposed example would be more helpful if it explains why the tax base equals cost if the expected manner of recovery is to hold to maturity. This could be done by repositioning the later explanation of the amounts that will be deductible on sale or at maturity.

BC7 BC7 argues that the economic benefit embodied in the related deferred tax asset results from the ability of the holder of the debt instrument to achieve future taxable gains in the amount of the deductible temporary difference without paying taxes on those gains. We question this reference to "taxable gains" given that the changes in fair value of the instrument while it is held are not taxable or tax deductible. In our view the economic benefit relates to the expectation of future accounting profits that will not be taxable.

BC7 BC7 also states that: "an entity that acquires the debt instrument described in the example illustrating paragraph 26(d) of IAS 12 for its fair value (in the example, CU918) and holds it to maturity has to pay taxes on a gain of CU82". This may or may not be the case depending on the tax law. In this example tax law does not explicitly specify any tax consequences resulting from the payment of the entire principal of CU1,000.

IE13 The statement: "This tax loss includes all the amounts that will be taxable or tax-deductible on the reversal of the temporary differences described in the previous paragraphs" should be clarified. This could be confusing. With reference to Instrument A, the reversal of the CU57,143 will be included as a gain in the accounting result but will not be included in the taxable profit (loss) because it is not taxable. We think it would be clearer to state the accounting profit or loss, then illustrate the adjustments to that figure to arrive at the CU200,000 ordinary tax loss.