

Deferred tax assets on unrealised losses

IASB consults on its revised proposals

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“The revised proposals are a welcome step towards addressing the fundamental question of what future taxable profit is. One thing is clear – it is not the bottom line on your tax return.”

– Thomas Schmid,
KPMG's global IFRS income taxes leader

Do you recognise a deferred tax asset if the loss is unrealised?

Answers to deferred tax questions are not always intuitive. Suppose that you hold a debt instrument that is falling in value, without a corresponding tax deduction. But you know that on the due date you will receive the full nominal amount, and there will be no tax consequences of that repayment. Do you recognise a deferred tax asset on this unrealised loss?

Proposals¹ issued by the IASB on 20 August 2014 attempt to bring clarity to this issue, which emerged during the financial crisis.

The detailed example in the proposals shows that the answer is 'yes', if certain conditions are met. This may be the case even if your future bottom line is expected to be a loss.

This may seem contrary to the key requirement that an entity recognises deferred tax assets only if it is probable that it will have future taxable profit. This brings us to the underlying question in the proposals ...

¹ Exposure draft *Recognition of Deferred Tax Assets for Unrealised Losses (Proposed amendments to IAS 12)*.

What is 'future taxable profit'?

Some would argue that the most intuitive answer to this question is the bottom line on the tax return – i.e. taxable income less tax-deductible expenses. However, this is not the IASB's view.

The following simplified example explains the IASB's proposals and illustrates how they would apply in practice.

Facts: Company P bought a debt instrument with a nominal value of 1,000. Its fair value on 31 December 2014 is 900. P determines that there is a deductible temporary difference of 100. P expects to hold the instrument until its maturity on 31 December 2015, and to collect the full 1,000 – i.e. the deductible temporary difference will reverse in full. In addition, P has a taxable temporary difference of 30 that will also reverse in 2015. P expects that the bottom line of its tax return in 2015 will be a tax loss of 20. P's income tax rate is 25%.

Question: Can P recognise a deferred tax asset?

Step 1: Reversal of taxable temporary differences

Under the existing requirements of IAS 12 *Income Taxes*, P considers whether it has a tax liability (from a taxable temporary difference) that will support the recognition of the tax asset (from a deductible temporary difference).

Deductible temporary difference	100
Reversing taxable temporary difference	(30)
Remaining amount to be tested for recognition	70

In Step 1, P can recognise a deferred tax asset in relation to unrealised losses of at least 30.

Step 2: Calculate future taxable profit

The IASB's proposals relate to how to perform Step 2, suggesting the formula to arrive at a figure for future taxable profit. In

essence, its aim is to arrive at the amount of tax profit or loss before the reversal of any temporary differences.

Expected tax loss per bottom line of tax return	(20)
Minus reversing taxable temporary difference (considered in Step 1)	(30)
Plus reversing deductible temporary difference	100
Taxable profit for recognition test	50

Step 3: Add results in Step 1 and Step 2 and calculate tax

P would recognise a deferred tax asset of 20 $((30 + 50) \times 25\%)$ despite having an expected loss on its tax return.

Broader implications

The proposals stem from a question about deferred taxes on unrealised losses on debt instruments, but they attempt to address the much broader issue of how to determine future taxable profit for the asset recognition test. The assumptions used in the illustrative examples may also impact the analysis in other circumstances. The broader implications of the proposals will need to be assessed as part of the response to the IASB.

Next steps

Comments are due to the IASB by 18 December 2014. For more information, go to the [IASB press release](#) or speak to your usual KPMG contact.