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Deferred tax assets

Clearer accounting

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IASB clarifies deferred tax treatment for debt instruments under IAS 12

Highlights

- Can you recognise a deferred tax asset if the loss is unrealised? – Yes, if certain conditions are met
- What is 'future taxable profit' for the recognition test? – Not the bottom line of the tax return
- Other questions addressed – The recognition assessment
- Effective date (2017 year ends) and potential impact

Can you recognise a deferred tax asset if a loss is unrealised?

Answers to deferred tax questions are not always intuitive. Consider the following narrow fact pattern.

> 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 *contractual* amount, and there will be no tax consequences of that repayment.
>
> Does this unrealised loss trigger a temporary difference and if so, do you recognise a deferred tax asset on it?

The amendments to IAS 12 *Income Taxes* issued by the IASB on 19 January bring some clarity to this issue, which emerged during the financial crisis.

The amendments clarify that the existence of a deductible temporary difference depends solely on a comparison of the carrying amount of an asset and its tax base at the end of the reporting period, and is not affected by possible future changes in the carrying amount or expected manner of recovery of the asset. Therefore, assuming that the tax base remains at the original cost of the debt instrument, there is a temporary difference.

The next question is whether you can recognise a deferred tax asset if the future bottom line of your tax return is expected to be a loss. The amendments show that the answer is 'yes', if certain conditions are met.

"Stemming from a relatively narrow question about deferred taxes on unrealised losses on debt instruments, the amendments address a much broader area of accounting for deferred tax assets in general, including the question of how to determine future taxable profit for the recognition test."

It could be argued that this appears contrary to the key requirement that a company 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 amendments...

What is 'future taxable profit' for the recognition test?

At present, various methods are used to calculate future taxable profit to establish whether a deferred tax asset can be recognised. Some have been using the expected bottom line on the tax return – i.e. future taxable income less tax-deductible expenses. This may seem like an intuitive approach at first glance. However, the amendments clarify that this approach will no longer be appropriate.

While this may appear counter-intuitive, it isn't really. In essence, the benefit of the deferred tax asset is in a reduction of future taxable income. To assess whether you can benefit from it, you need to start with the taxable income before the deduction rather than with the bottom line, to avoid double counting.

If, at present, you calculate your future taxable profit for the recognition test before the effect of reversing temporary differences, then the amendments are unlikely to impact you. However, if your future taxable profit for the recognition test is the future bottom line of the tax return, then you need to reverse out such temporary differences to avoid double counting.

Our worked example illustrates how the amendments will apply in practice, and also that it is now possible for a company to recognise deferred tax assets despite having an expected loss on its tax return.

Other recognition questions addressed

Questions	Answers
Can an entity assume that it will recover an asset for more than its carrying amount?	Yes – if there is sufficient evidence that it is probable that the entity will achieve this. For example, this may be achievable if the entity measures property, plant and equipment at cost and expects to generate benefits exceeding that cost or it has a fixed-rate debt instrument measured at fair value, but expects to collect all contractual cash flows. Conversely, for other assets measured at fair value it may be more difficult to argue that this is achievable.
Are deductible temporary differences related to unrealised losses assessed separately for recognition?	No – they are assessed on a combined basis, unless a tax law restricts the use of losses to deductions against income of a specific type.

Effective date and potential impact

The amendments are effective for annual periods beginning on or after 1 January 2017.

The impact on your financial statements will depend on your tax environment and how you currently account for deferred taxes.

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Worked example

Deferred tax assets

What is 'future taxable profit' for the recognition test?

Applying the IAS 12 amendments | January 2016

Fact pattern:

1 Jul 2015

P buys debt instrument
at nominal value: 1,000

P's income tax rate for all periods is 25%

31 Dec 2015

Fair value due to market rate change: 900

Deductible temporary difference (**DTD**): 100

P also has a taxable temporary difference (**TTD**) reversing in 2016: 30

31 Dec 2016

Instrument matures

P expects to collect full 1,000 – i.e. DTD expected to reverse

Expected tax loss on bottom line of tax return: (20)

Can P recognise a deferred tax asset? And if so, at what amount?

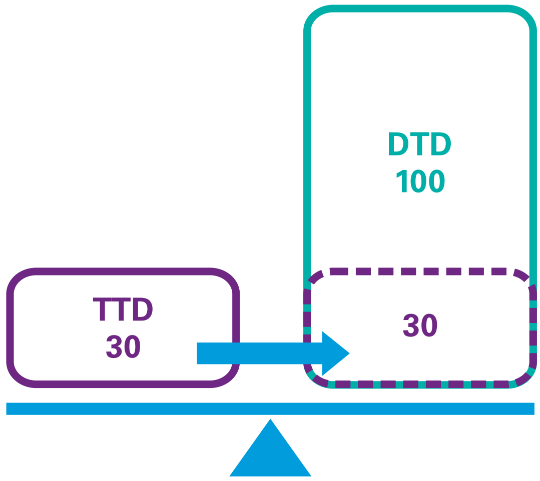
The short answer is 'Yes'
if certain conditions are met

But how do we get there?

Read on for our detailed analysis based on the IASB's explanation.

Analysis based on the IASB's explanation

Step 1 Are there taxable temporary differences that reverse?
(Existing requirements)



TTD of 30 will reverse and generate taxable income against which DTD can be utilised.

Therefore in Step 1, **P can recognise 30 of the DTD in calculating the deferred tax asset.**

This amount may increase if there is a future taxable profit (see Step 2).

Step 2 What is the 'future taxable profit'?
(Clarified requirements)

Bottom line (20) − TTD 30 + DTD 100 = Future taxable profit 50

The future taxable profit for the purpose of the recognition test is 50, being the bottom line of the tax return adjusted for the reversing TTD and DTD to avoid double counting.

Step 3 What amount should P recognise as a deferred tax asset?

30 + 50 = 80 × 25% = 20

P adds the amounts from **Step 1** and **Step 2** and applies its tax rate to the total.