Recognising deferred tax on leases

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Fred Versteeg
Partner, Department of Professional Practice

KPMG in the Netherlands

Narrowing the scope of IAS 12's initial recognition exemption to improve comparability

Highlights

- What's the issue – Diversity in recognising deferred taxes on leases and decommissioning obligations
- Recognition exemption narrowed – Tax impact should be reflected in the financial statements
- Effective date and transition – Apply from 1 January 2023

Targeted amendments[1] to IAS 12 *Income Taxes* clarify how companies should account for deferred tax on certain transactions – e.g. leases and decommissioning provisions.

The amendments narrow the scope of the initial recognition exemption (IRE) so that it does not apply to transactions that give rise to equal and offsetting temporary differences. As a result, companies will need to recognise a deferred tax asset and a deferred tax liability for temporary differences arising on initial recognition of a lease and a decommissioning provision.

What's the issue?

Currently, there is diversity in practice when accounting for deferred tax on transactions that involve recognising both an asset and a liability with a single tax treatment related to both.

For example, a company may be entitled to a tax deduction on a cash basis for a lease transaction that involves recognising a right-of-use (ROU) asset and a corresponding lease liability under IFRS 16 *Leases*[2]. A temporary difference may then arise on initial recognition of the ROU asset and the lease liability. When applying the IRE to this temporary difference, a company may currently apply one of the following approaches.

"By limiting the initial recognition exemption, the amendments will improve comparability and provide more relevant information to the users of financial statements about the tax consequences of leases and decommissioning obligations."

Fred Versteeg
KPMG global IFRS income tax leader

1 *Deferred Tax related to Assets and Liabilities arising from a Single Transaction (Amendments to IAS 12).*

2 The amendments have been explained using leases as an example; they would also apply to the recognition of decommissioning liabilities and corresponding adjustment to the asset.

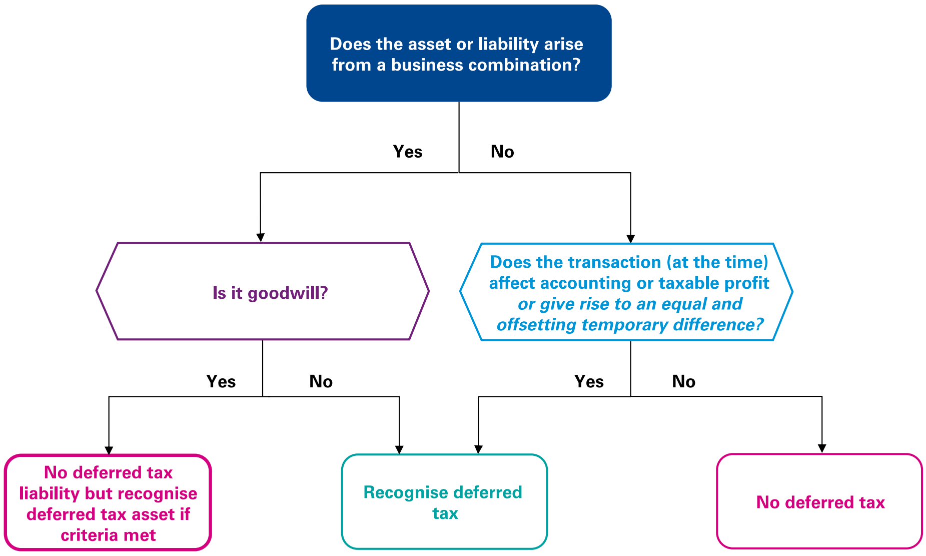
Approach	Outcome
Apply the IRE separately to the ROU asset and lease liability	Recognise the tax impacts in profit or loss when they are incurred and therefore recognise no deferred tax on the lease
Assess the ROU asset and lease liability together as a single or 'integrally linked' transaction on a net basis	Recognise deferred tax on a net temporary difference that arises after the initial recognition and is not subject to the IRE
Choose not to apply the IRE	Recognise deferred tax

In short, not all companies reflect the future tax impacts of leases in their financial statements.

Recognition exemption narrowed

The amendments clarify that the exemption does not apply to transactions such as leases and decommissioning obligations. These transactions give rise to equal and offsetting temporary differences and this **example** illustrates how a company applies the amendments.

All companies will now need to reflect the future tax impacts of these transactions and recognise deferred tax, as illustrated below.



Effective date and transition

The amendments apply for annual reporting periods beginning on or after 1 January 2023. Earlier application is permitted.

For leases and decommissioning liabilities, the associated deferred tax asset and liabilities will need to be recognised from the beginning of the earliest comparative period presented, with any cumulative effect recognised as an adjustment to retained earnings or other components of equity at that date. If a company previously accounted for deferred tax on leases and decommissioning liabilities under the net approach, then the impact on transition is likely to be limited to the separate presentation of the deferred tax asset and the deferred tax liability. This **example** illustrates the requirements on transition.

For all other transactions, the amendments apply to transactions that occur after the beginning of the earliest period presented.

Illustrative examples

1. Leases

Company C enters into a 10-year lease of a building and recognises a right-of-use asset and a lease liability of 450. In addition, C incurs initial direct costs of 20.

On commencement of the lease, C records the following entries under IFRS 16 *Leases*.

	Debit	Credit
Right-of-use asset	450	
Lease liability		450
To recognise lease liability and right-of-use asset		
Right-of-use asset	20	
Cash		20
To recognise initial direct costs		

Local tax legislation allows tax deductions for lease payments and initial direct costs when they are paid. Economic benefits that will flow to C when it recovers the carrying amount of the right-of-use asset will be taxable. After considering the applicable tax legislation, C concludes that the tax deductions that it will receive for lease payments relate to the repayment of the lease liability.

The corporate tax rate is 20%.

C determines the temporary differences that arise on initial recognition of the lease as follows.

	Carrying amount	Tax base	Deductible (taxable) temporary difference	Deferred tax asset (liability) at 20%
Right-of-use asset				
– Initial direct cost	20	-[a]	(20)	(4)
– Initial measurement of lease liability	450	-[b]	(450)	(90)
Lease liability	(450)	-[c]	450	90

Notes

IAS 12.15(b)(ii)

a. The tax base of the initial direct costs is zero because C has already used the deduction for tax purposes when it made the payment. Because this transaction affected the taxable profit on initial recognition, C recognises a deferred tax liability for the taxable temporary difference of 20.

IAS 12.7

b. The tax base of the right-of-use asset is zero because the tax deduction relates to the lease liability and no tax deduction will be available for the asset.

IAS 12.8

c. The tax base of the lease liability is zero because it is determined as the carrying amount of 450 less the future tax deduction of 450.

On commencement of the lease, C records the following entry for the temporary differences.

	Debit	Credit
Income tax expense	4	
Deferred tax liability		94
Deferred tax asset	90	
To recognise deferred tax on initial recognition of the lease		

2. Decommissioning liability

Company B recognises a provision of 100 for decommissioning its nuclear plant, which it capitalised as part of the cost of the plant. For tax purposes, the expenditure will be deducted only when it is incurred and the tax deduction is allocated to the decommissioning liability.

The corporate tax rate is 30%.

B records the following entry to recognise the decommissioning liability.

	Debit	Credit
Property, plant and equipment	100	
Decommissioning liability		100
To recognise the decommissioning liability		

B determines the temporary differences arising on initial recognition of the decommissioning liability as follows.

	Carrying amount	Tax base	Deductible (taxable) temporary difference	Deferred tax asset (liability) at 30%
Property, plant and equipment	100	-[a]	(100)	(30)
Decommissioning liability	100	-[b]	100	30

Notes

IAS 12.7

a. The tax base of the property, plant and equipment is zero because the tax deduction relates to the decommissioning liability and no tax deduction will be available for the asset.

IAS 12.8

b. The tax base of the decommissioning liability is zero because it is determined as the carrying amount of 100 less the future tax deduction of 100.

On initial recognition of the decommissioning liability, B records the following entry for the temporary differences.

	Debit	Credit
Deferred tax asset	30	
Deferred tax liability		30
To recognise deferred tax on property, plant and equipment and the decommissioning liability		

Illustrative example – Transition

On 1 January 2018, Company M and Company N each entered into a 10-year lease of a building with the following identical terms.

- The annual lease payments of 15 are payable at the end of each year.
- The interest rate implicit in the lease cannot be readily determined. The lessee's incremental borrowing rate is 8.15%.

The right-of-use asset and the lease liability at the relevant dates are as follows.

	Right-of-use asset	Lease liability
1 January 2018	100	(100)
1 January 2022	60	(69)
1 January 2023	50	(60)
31 December 2023	40	(50)

M and N adopt the IAS 12 amendments[1] in their annual financial statements for the period ending 31 December 2023 and present comparatives for one year – i.e. the beginning of the earliest comparative period presented is 1 January 2022.

Previously, M accounted for deferred tax on a lease under the net approach – i.e. it assessed the temporary differences on a net basis. N applied the initial recognition exemption and therefore recognised no deferred tax for leases. M and N determine the temporary differences relating to the right-of-use asset and the lease liability at 1 January 2022 as follows.

The corporate tax rate is 30%.

	Carrying amount	Tax base	Deductible (taxable) temporary difference	Deferred tax asset (liability) at 30%
Right-of-use asset	60	-	(60)	(18)
Lease liability	(69)	-	69	21
Net approach	(9)	-	9	3

M and N determine that the deferred tax asset meets the recognition criteria in IAS 12.

Because M previously accounted for deferred tax on a lease under the net approach, it records the following entry on transition (1 January 2022) in its statement of financial position to present separately the deferred tax asset and the deferred tax liability relating to the lease.

	Debit	Credit
Deferred tax asset	18*	
Deferred tax liability		18
To present separately deferred tax asset and deferred tax liability		

* M has already recognised deferred tax of 3 at 1 January 2022 so the deferred tax asset becomes 21.

There is no impact on M's retained earnings at 1 January 2022.

N previously applied the initial recognition exemption and recognised no deferred tax for leases. Therefore, N records the following entry on transition (1 January 2022) to recognise the deferred tax asset and the deferred tax liability relating to the lease.

	Debit	Credit
Deferred tax asset	21	
Deferred tax liability		18
Retained earnings		3
To recognise deferred tax asset and deferred tax liability on transition		

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