KPMG IFRG Limited
15 Canada Square
London E14 5GL
United Kingdom

Reinhard.Dotzlaw@kpmgifrg.com

Mr Hans Hoogervorst
International Accounting Standards Board
Columbus Building
7 Westferry Circus
London
E14 4HD

Our ref RD/288

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Dear Mr Hoogervorst

Comment Letter on Exposure Draft ED/2019/5 Deferred Tax related to Assets and Liabilities arising from a Single Transaction – Proposed amendments to IAS 12

We appreciate the opportunity to comment on the International Accounting Standards Board's (the Board's) Exposure Draft *Deferred Tax related to Assets and Liabilities arising from a Single Transaction – Proposed amendments to IAS 12*. We have consulted with, and this letter represents the views of, the KPMG network.

We support the Board's proposal to limit the application of the initial recognition exemption in paragraphs 15 and 24 of IAS 12 *Income Taxes* so that it does not apply to transactions that involve the recognition of an asset and a liability with a single tax treatment related to both – e.g. recognition of a lease liability and right-of-use asset, or a decommissioning liability and corresponding increase in the carrying amount of an asset.

We believe that the proposed amendments are timely. They will address the current diversity in practice, which became more extensive with the introduction of IFRS 16 *Leases*, and will improve comparability of financial information. The proposals will also result in tax accounting that better reflects the economics of transactions in which the asset and the liability are integrally linked and will enhance the relevance of information for the users of financial statements.

Notwithstanding our overall support for the Board's approach to addressing the matter, we note that some concerns have been raised about the clarity of the proposals and potential application issues, particularly in relation to the recoverability test and the transition provisions. We believe that most of those concerns could be addressed by providing clarifications and including examples illustrating how the proposals should be applied in various circumstances.

The Appendix to this letter contains our detailed response to the question in the exposure draft.

Please contact Reinhard Dotzlaw at Reinhard.Dotzlaw@kpmgifrg.com or Fred Versteeg at Versteeg.Fred@kpmg.nl if you wish to discuss any of the issues raised in this letter.

Yours sincerely

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Appendix

Question
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 support the Board's proposal to require an entity to recognise deferred tax on transactions that involve the recognition of an asset and a liability with a single tax treatment related to both and give rise to deductible and taxable temporary differences of equal amounts. However, we believe that clarifications may be necessary on how to interpret and apply some aspects of the proposals.

Applying the recoverability test and determining taxable profit for the recognition assessment

Paragraph 22A of the proposed amendments explains the recognition requirements for a deferred tax asset and deferred tax liability in a transaction in which equal amounts of taxable and deductible temporary differences arise on initial recognition. The proposed requirements:

- limit the recognition of the deferred tax asset to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised; and
- limit the recognition of the deferred tax liability to the amount of the deferred tax asset recognised.

Some have raised concerns that it is not sufficiently clear how the proposals would apply in practice. In fact, the logic for the recognition test may appear to be opposite to the existing requirements – i.e. the amount of the deferred tax liability is limited to the amount of the recognised deferred tax asset rather than the other way around. This may imply that the asset recognition is assessed first. However, because the deferred tax liability is not recognised at that stage, taxable profit from the reversal of the temporary difference cannot be considered as part of the recoverability test.

While we do not think that it was the Board's intention *not* to consider taxable profits from the reversal of taxable temporary differences in assessing the recoverability of a deferred tax asset, we are concerned that some may use this as an argument for not reflecting the income tax consequences of leases or decommissioning provisions in financial statements.

To address these concerns, we believe that paragraph 22A should specifically state that the taxable profits to be considered in the recoverability assessment include those from the reversal of taxable temporary differences arising from the same transaction. We acknowledge that paragraph 21 of the Basis for Conclusions highlights that, for a lease transaction, an entity would generally meet the recoverability requirements for recognition of a deferred tax asset through the future reversal of taxable temporary differences. However, we believe that a clarification in the body of the standard will ensure that the reversing taxable temporary differences are included in the recoverability assessment by highlighting the requirements in paragraph 28 of IAS 12.

The proposed addition to paragraph 22A(a):

22A ….. In that situation, on initial recognition of the transaction, an entity recognises:

(a) a deferred tax asset for the deductible temporary difference to the extent that it is probable that taxable profit will be available (<u>including taxable profit from the reversal of taxable temporary differences from the same transaction</u>) against which the deductible temporary differences can be utilised.

Reassessment of unrecognised deferred tax assets and subsequent measurement of the deferred tax liability

While we appreciate the Board's arguments for not addressing the reassessment of unrecognised deferred tax assets, we do not believe that the existing guidance in paragraph 37 of IAS 12 would be sufficient in determining how to subsequently remeasure the deferred tax liability which was limited on initial recognition – i.e. whether the deferred tax liability will continue to be limited to the original amount recognised or will be remeasured to reflect any subsequent increases in the deferred tax asset.

We recommend that the Board clarify if and how to remeasure deferred tax liabilities that were limited on initial recognition by the amount of recognised deferred tax asset.

Transition requirements

Application of transition relief

On the date of transition, an existing lease is unlikely to have equal and offsetting differences. We note that the 'fully retrospective' approach in paragraph 98J and the 'modified retrospective' approach in paragraph 98K may lead to different accounting outcomes in cases in which the amount of taxable temporary differences exceeds the amount of deductible temporary differences on transition. This is because the transition relief in paragraph 98K limits the recognition of the deferred tax liability to the recognised deferred tax asset, whilst paragraph 98J does not limit the recognition of the deferred tax liability.

Consider the following examples.

Scenario A and B

Fact pattern

- Entity B has an existing lease that does not have equal and offsetting differences.
- On the date of transition, B has a deductible temporary difference of 200 and a taxable temporary difference of 300.
- B determines that the full amount of the deductible temporary difference can be recognised, regardless of whether the recoverability assessment is performed retrospectively applying paragraph 98J or applying the transition relief of paragraph 98K.
- B's tax rate is 50%.

Scenario C

Fact pattern

- On the date of transition, B has a deductible temporary difference of 400 and a taxable temporary difference of 300.
- B determines that the full amount of the deductible temporary difference can be recognised, regardless of whether the recoverability assessment is performed retrospectively applying paragraph 98J or applying the transition relief of paragraph 98K.
- B's tax rate is 50%.

	Scenario A – Applying paragraph 98J	**Scenario B – Applying paragraph 98K**	**Scenario C – Applying either paragraph 98J or 98K**
Recognised deferred tax asset	100	100	200
Deferred tax liability	(150)	(100)	(150)
Adjustment to opening retained earnings	50	-	(50)
Rationale	Paragraph 98J does not limit the recognition of the deferred tax liability to the deferred tax asset.	Paragraph 98K limits the recognition of the deferred tax liability to the extent of the deferred tax asset.	Regardless of the transition option, the deferred tax liability will be recognised in full when the deferred tax asset is greater than the liability.

We understand that the objective of the transition relief in paragraph 98K is to allow an entity to perform a recoverability assessment based on the facts and circumstances at the beginning of the earliest comparative period presented rather than at the date of the initial recognition of the transaction, and we support it. However, it is unclear why this relief is accompanied by a limit to the deferred tax liability and why the two approaches would lead to different accounting outcomes in some cases.

We support limiting the recognition of deferred tax liability to the amount of recognised deferred tax asset on *initial recognition* of a transaction, but do not believe that arguments in paragraph 22(c) of IAS 12 are relevant on transition and therefore recommend that the limit in paragraph 98K is removed.

Retrospective application of proposed amendments

Paragraph 98J requires the proposed amendments to be applied retrospectively, unless the entity applies the transition approach specified in paragraph 98K. Similar to other Standards which require retrospective application, we believe that paragraph 98J should allow it only if that is possible without the use of hindsight. This is because estimates and judgements may be required to apply the proposed amendments retrospectively.

Interaction with transition approaches in IFRS 16

Although the amendments will become effective after the adoption of IFRS 16, the Board needs to consider how the transition provisions in IFRS 16 interact with those in the proposed amendments.

A large majority of entities applied the new leases standard using the modified retrospective approach – e.g. an entity with a calendar year-end reporting date recognised lease assets and liabilities at 1 January 2019. Further, an entity that applied a modified retrospective approach could then choose, on a lease-by-lease basis, whether to measure the right-of-use asset at that date at an amount equal to the lease liability, or retrospectively.

It is unclear how such an entity would apply the proposed amendments retrospectively in accordance with paragraph 98J or paragraph 98K. For example, would the entity effectively need to apply the leases standard retrospectively, or could it use information prepared for transition to IFRS 16? If the entity elects not to measure the right-of-use asset by reference to the lease liability at 1 January 2019, does this impact the analysis? We recommend that the Board clarify this.

Illustrative examples

As mentioned earlier, we agree with the Board's approach to addressing the issue at hand. However, some raise concerns that the drafting of the proposed amendments is not intuitive and that it may not be clear how to apply them to more complex transactions in practice. To address such concerns, we recommend that the Board include a series of examples to illustrate how to apply the requirements to various scenarios, involving the following.

— Temporary differences reversing in different periods. This example would be relevant for decommissioning obligations for which deductions are available when payments are made and the deferred tax liability has been limited on initial recognition due to the recoverability assessment.

— Deductions attributed to the asset but the tax base being different from the carrying amount on initial recognition. It is unclear from paragraph BC7 how the proposals would apply to a scenario in which a tax deduction is attributed to the asset but that deduction is higher or lower than the asset's carrying amount – i.e. there is no temporary difference on the liability side but there is one on the asset side. In that example, it would be helpful to illustrate how an entity determines that the deduction is attributed to the asset rather than the liability.

— Initial direct costs recognised as part of the cost of the right-of-use asset. Paragraphs BC16–BC18 that address advance lease payments and initial direct costs imply that the initial direct costs are a separate unit of account to be assessed on initial recognition, and therefore do not impact temporary differences related to the right-of-use asset and the lease liability – i.e. they do not give rise to unequal temporary differences on initial recognition. An example illustrating this would be helpful.

— Application of the initial recognition exemption to the extent than an entity would otherwise recognise unequal amounts of deferred tax assets and liabilities and the reassessment of unrecognised deferred tax assets and subsequent measurement of the deferred tax liability. As previously indicated, we do not believe that the existing guidance in paragraph 37 of IAS 12 would be sufficient in determining how to remeasure subsequently the deferred tax liability which was limited on initial recognition. This may be more challenging in situations in which the right-of-use asset is subsequently measured at fair value (e.g. investment property) or when temporary differences reverse in different periods (e.g. decommissioning liabilities).