

IFRS Developments

IASB clarifies deferred tax accounting for leases and decommissioning obligations

What you need to know

- ▶ The IASB has amended IAS 12 to clarify that the initial recognition exception does not apply to the initial recognition of leases and decommissioning obligations.
- ▶ The amendments apply for annual reporting periods beginning on or after 1 January 2023 and may be applied early.
- ▶ The amendments apply prospectively to transactions that occur on or after the beginning of the earliest comparative period presented. In addition, an entity should apply the amendments for the first time by recognising deferred tax for all temporary differences related to leases and decommissioning obligations at the beginning of the earliest comparative period presented.

Highlights

On 7 May 2021, the International Accounting Standards Board (the IASB or Board) issued *Deferred Tax related to Assets and Liabilities arising from a Single Transaction - Amendments to IAS 12* (the Amendments). The Board amended the standard to reduce diversity in the way that entities account for deferred tax on transactions and events, such as leases and decommissioning obligations, that lead to the initial recognition of both an asset and a liability.

The Amendments narrow the scope of the initial recognition exception under IAS 12 *Income Taxes*, so that it no longer applies to transactions that give rise to equal taxable and deductible temporary differences. The Amendments also clarify that where payments that settle a liability are deductible for tax purposes, it is a matter of judgement (having considered the applicable tax law) whether such deductions are attributable for tax purposes to the liability recognised in the financial statements (and interest expense) or to the related asset component (and interest expense). This judgement is important in determining whether any temporary differences exist on initial recognition of the asset and liability.

The Amendments apply to annual reporting periods beginning on or after 1 January 2023, with earlier application permitted.

Amendments to IAS 12

For simplicity, the basis for the Amendments is explained using leases as an example. This explanation applies equally to similar transactions and events, such as decommissioning obligations.

Determining the tax base of assets and liabilities

An entity that applies IFRS 16 *Leases* recognises a right-of-use asset (lease asset) and a lease liability at the commencement date of a lease. On initial recognition, the entity needs to assess the tax base of the lease asset and liability by identifying the amounts attributable to them for tax purposes. In a jurisdiction where an entity receives tax deductions when it makes lease payments, it applies judgement in determining whether those tax deductions are attributable to:

- ▶ The lease asset (and interest expense) because the deductions relate to the expenses (i.e., depreciation and interest expense) arising from the lease

Or

- ▶ The lease liability (and interest expense) because the deductions relate to the repayment of the lease liability and interest expense.

If the tax deductions are attributed to the lease asset, the tax bases of the lease asset and lease liability equal their carrying amounts, and no temporary differences arise on initial recognition. However, if the tax deductions are attributed to the lease liability, the tax bases of the lease asset and lease liability are nil, giving rise to taxable and deductible temporary differences in respect of the asset and the liability, respectively. If those gross temporary differences are equal, the Amendments require that a deferred tax liability and a deferred tax asset are recognised.

The Board decided not to provide application guidance to help entities assess whether tax deductions are attributable to the lease asset or lease liabilities, as the costs of doing so would outweigh the benefits. An entity will need to make a judgement, having considered the applicable tax law, whether tax deductions relate to the lease asset or lease liability.

Changes to the initial recognition exception

IAS 12 contains exceptions from recognising the deferred tax effects of certain temporary differences arising on the initial recognition of some assets and liabilities, generally referred to as the 'initial recognition exception' or 'initial recognition exemption', sometimes abbreviated to 'IRE'. 'Exception' is the more accurate description, since a reporting entity is required to apply it, rather than having the option to do so implicit in the term 'exemption'.

Before the Amendments were issued, views differed on whether (and to what extent) the IRE applied to transactions and events, such as leases, that lead to the recognition of an asset and a liability. To address this problem, the IASB decided to narrow the scope of the recognition exception so that it does not apply to transactions that, on initial recognition, give rise to equal taxable and deductible temporary differences.

Only if the recognition of a lease asset and lease liability (or decommissioning liability and decommissioning asset component) give rise to taxable and deductible temporary differences that are not equal, would the IRE be applied.

The Amendments do not change the fact that the initial recognition exception applies only to temporary differences arising on initial recognition of an asset or liability. It does not apply to new temporary differences that arise on the same asset or liability after initial recognition. When the exception has been applied to the temporary difference arising on initial recognition of an asset or liability, and there is a different temporary difference associated with that asset or liability at a subsequent date, it is necessary to analyse the temporary difference at that date between:

- ▶ Any amount relating to the original temporary difference (on which no deferred tax is recognised)
- And
- ▶ The remainder, which has implicitly arisen after initial recognition of the asset or liability (on which deferred tax is recognised)

When the deferred tax asset and deferred tax liability are not equal

The Amendments require entities to recognise a separate deferred tax asset (DTA) and deferred tax liability (DTL) when the *temporary differences* arising on the initial recognition of an asset and liability are equal. Nevertheless, it is possible that those DTAs and DTLs are not equal, for example, because:

- ▶ An entity may recognise a deferred tax liability, but is unable to recognise an equal and offsetting deferred tax asset if it is unable to benefit from the tax deductions
- Or
- ▶ Different tax rates may apply to the taxable and deductible temporary differences

In the above scenarios, which the Board expects to occur infrequently, an entity would need to account for the difference between the deferred tax asset and liability in profit or loss.

Advance lease payments and initial direct costs

Having initially measured a lease liability at the present value of the lease payments not yet made at the commencement date and recognised a related component of the lease asset, entities will adjust the measurement of the lease asset for any advance lease payments or initial direct costs incurred. The Board notes that these adjustments could result in additional taxable temporary differences associated with the lease asset, to which an entity would apply the relevant requirements in IAS 12.

Transition and effective date

An entity should apply the Amendments for annual reporting periods beginning on or after 1 January 2023. Earlier application is permitted, but an entity should disclose that fact.

An entity should apply the Amendments to transactions that occur on or after the beginning of the earliest comparative period presented. In addition, at the beginning of the earliest comparative period presented, it should also:

- ▶ Recognise a 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 a deferred tax liability for all deductible and taxable temporary differences associated with:
 - ▶ Right-of-use assets and lease liabilities
- And
- ▶ Decommissioning, restoration and similar liabilities and the corresponding amounts recognised as part of the cost of the related asset
- And

- ▶ Recognise the cumulative effect of initially applying the Amendments as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at that date

The above transitional provisions also apply to first-time adopters at the date of their transition to IFRSs.

How we see it

Entities are required to recognise deferred tax assets and liabilities for temporary differences, if any, arising from the initial recognition of a lease and subsequently. An entity would typically offset these deferred tax assets and liabilities in the statement of financial position, but the ability to do so should be confirmed by reference to the applicable tax law.

The Amendments could, in some cases, lead to the recognition of unequal amounts of deferred tax assets and liabilities, despite the gross deductible and taxable temporary differences being equal. In such cases, an entity would need to account for the difference between the deferred tax asset and liability in profit or loss. This outcome is much less complicated than the original capping proposals, which would have given rise to significant complexity in the application of IAS 12.

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