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14 November 2019

Hans Hoogervorst
Chair
International Accounting Standards Board
Columbus Building
7 Westferry Circus
Canary Wharf
London
E14 4HD

Dear Mr Hoogervorst

Exposure Draft 2019/5 – Deferred Tax related to Assets and Liabilities arising from a Single Transaction

Deloitte Touche Tohmatsu Limited is pleased to respond to the International Accounting Standards Board's ('the IASB's') exposure draft *Deferred Tax related to Assets and Liabilities arising from a Single Transaction*.

We support the efforts of the IASB to address an issue that has been the source of diversity in practice and that is likely to increase as a result of the application of IFRS 16 Leases. Currently, most entities faced with the issue either apply IAS 12 separately to the asset and liability (i.e., no deferred taxes are recognised on initial recognition or subsequently because of the application of the initial recognition exemption (IRE) to the temporary difference on the asset and the liability) or they apply the requirements of IAS 12 to the transaction as a whole (i.e., no deferred taxes are recognised initially because the transaction results in a nil net asset but deferred taxes are recognised subsequently as the carrying amount of the asset and liability diverge). We believe that either of these approaches is acceptable under IAS 12 and that diversity could have been addressed by the Board proposing the method it considered most relevant through an Interpretation of IAS 12.

The accounting treatment resulting from the proposals in the ED is more complex than the methods currently applied by entities. To ensure that the amendments achieve the objective of reducing diversity in practice, further clarification beyond those proposed in the ED will be required. The Board may wish to reconsider whether, in the context of a narrow scope project, it may be preferable to address diversity in practice through an Interpretation (as discussed in BC13 to BC15) and consider whether changes should be made to the IRE as part of a more comprehensive review of the IRE. If the Board pursues modifying the scope of the IRE, we note that important elements of the proposed approach are currently discussed in the Basis for Conclusions. We believe that it is important that these elements be brought into IAS 12 itself. An illustrative example of the proposed approach would also be helpful. Our specific concerns regarding the need for further clarification are presented in the Appendix to this letter.

As further explained in our detailed response, we believe that a key difficulty that needs to be address is the identification of transactions that are indeed subject to the IRE.

We note that the Board proposes transition relief to permit entities on adoption of the proposed amendments to assess the recoverability requirement only at the beginning of the earliest comparative period presented. We suggest that the transition relief be expanded such that entities are permitted to recognise and measure

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deferred tax amounts based on the temporary differences determined at the beginning of the earliest comparative period presented with the difference recognised in opening retained earnings (or component of equity). This appears appropriate considering that deferred tax assets and liabilities are reassessed and remeasured at each reporting period. We believe that the same transition relief should be offered to first-time adopters for the same reason.

If you have any questions concerning our comments, please contact Veronica Poole in London at +44 (0) 20 7007 0884.

Yours sincerely

Veronica Poole
Global IFRS Leader

Appendix 1

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?

As noted in our cover letter, we believe that the Board's proposal to address the application of IAS 12 to transactions that result in equal amounts of deferred tax asset (DTA) and deferred tax liability (DTL) is more complex that suggested in the ED.

As noted in our cover letter, we believe that the transition relief proposed should be expanded (and simplified) so that entities are permitted to recognise and measure deferred tax amounts based on the temporary differences determined at the beginning of the earliest comparative period presented, with the difference recognised in opening retained earnings (or component of equity). The same transition relief should be offered to first-time adopters.

To achieve its objective of reducing diversity in practice, we believe that the following issues need to be clarified within IAS 12 itself.

a) *Proposed paragraph 22A*
We suggest that the requirements in proposed paragraph 22A be further explained so that it is clear that when assessing the recoverability of a deductible temporary difference, an entity considers the reversal of the taxable temporary difference arising in the same transaction as a source of profit. We understand that this is the case from the discussions in BC19-BC24. These paragraphs appear to indicate that paragraph 22A caters to the situations where an entity is unable to rely on the reversal of the taxable temporary difference as a source of profit for the recovery of the DTA because, for example, the deductible and taxable temporary differences reverse in different periods.

The potential confusion as to whether the reversal of the related DTL is a source of profit arises from the fact that the determination of the amount of the DTA and DTL to be recognised appears to be performed in a specific sequence in paragraph 22A (first the DTA and then the DTL). This may be addressed through an illustration of the application of the requirements.

We also believe that it is necessary to explain clearly within the body of IAS 12 the consequences of limiting the recognition of DTA to its recoverable amount, namely whether

i) The unrecognised DTL (the amount subject to the cap in 22A(b)) is subject to the IRE requirements in paragraph 22(c) such that it is not subsequently recognised; and
ii) The unrecognised DTA (because recoverability is not probable at the time of the transaction) may be recognised subsequently, upon reassessment of its recoverability (i.e. it is not subject to the requirements in paragraph 22(c))?

We note that the Board acknowledged that different entities may reach different conclusions with respect to the subsequent reassessment of the unrecognised DTA but decided not to address this issue to avoid adding complexity. While we agree that addressing this issue will add complexity, we believe that the issue is likely to arise in practice. We do not believe that explaining the expected accounting treatment solely in the Basis for Conclusion is an appropriate solution.

b) *Limiting the IRE to transactions that do not give rise to equal amounts of taxable and temporary differences*
As noted in BC19, equal amount of taxable and deductible temporary differences may result in unequal amounts of DTA and DTL because of a recoverability issue. Subject to the comments raised in a), we believe that this is appropriately addressed in the ED.

However, we believe that recoverability may not be the only reason why this situation would arise. For example, taxable and deductible temporary differences may reverse in different periods and if different tax rates are applicable to different periods, the resulting DTA and DTL may not be equal on

initial recognition of the transaction despite equal taxable and deductible temporary differences. This situation is likely to arise, for example, where an entity is subject to graduated rates of income tax or if different substantially enacted income tax rates apply in different periods. This is not unusual and may result in the DTL determined applying proposed paragraph 22A being lower than the DTA. Therefore this issue (whether the excess DTA is recognised and if so, how to account for the balancing credit) needs to be addressed as part of the deliberations of the ED. There may be other situations where equal amounts of taxable and deductible temporary differences may give rise to unequal amounts of DTA and DTL.

c) *Application of judgement in determining whether the tax deductions relate to the asset or liability*
BC6 indicates that an entity applies judgement in determining whether the tax deductions relate to the lease asset or the lease liability. BC7 and BC8 explain the consequences of this assessment. In many jurisdictions, the tax regulations may simply indicate that a tax deduction is available when a lease payment (cash payment) is made to the lessor. Without further guidance, entities operating in similar tax regimes may come to a different conclusion. We believe that this can be clarified by noting that in some jurisdictions, the tax treatment of leases is consistent with the accounting treatment (a deduction is available for the asset depreciation and for finance costs), whereas in other jurisdictions, the tax deduction is available only for lease payments as they are made (indicating the deductions relate to repayment of the lease liability). We also believe that since this concept is fundamental (considering the significantly different consequences described in BC7 and BC8), the principles in BC6-BC8 need to be presented as part of IAS 12 itself (along with the appropriate guidance explaining its application).

BC7(a) indicates that if the tax deductions relate to the lease asset, the tax bases of the lease asset and the lease liability equal their carrying amounts, reflecting that the entity will receive tax deductions equal to the carrying amount of the lease asset (and no tax deductions in respect of the lease liability). This conclusion is premised on the fact that in such situations the lease payments would be split for tax purposes between those that are on account of depreciation (corresponding to the initial carrying amount of the ROU) and those that are on account of interest payments (that will arise in the future) as noted in BC5. This should also be made clearer. In the absence of such a clarification, an entity may conclude that because the total tax deductions that will be received in the future is in fact greater than the carrying amount of the tax asset, there is a deductible temporary difference on initial recognition of the lease asset. Further, the assessment of whether the tax deductions relate to depreciation or to interest may give rise to difficulties in practice if the tax regulations do not make the distinction or distinguish the interest component of the deduction using an interest rate different from the rate used in applying IFRS 16.

d) Scope of the transaction considered in applying the proposed amendments and cases where the transaction may give rise to unequal amounts of deductible and taxable temporary differences
BC16-BC18 address a specific example of a much broader issue which is determining what is included in the transaction to assess whether the transaction (i) affects accounting profit or taxable profit and (ii) gives rise to equal amounts of taxable and deductible temporary differences.

BC16-BC18 highlight the effect of advance payment and initial direct costs. It is not clear whether the conclusion reached in BC18 is based on the fact that

(i) The advance payments and initial direct costs are considered to represent separate transactions, such that the requirements of paragraphs 15 and 24 are applied to these items separately from the right-of-use asset and lease liability. We understand how this may be the case with respect to the initial direct costs that are paid to a third party, however we are less clear about the advance payments that adjust the carrying amount of the right-of-use asset upon initial recognition; or
(ii) While the amounts form part of the same transaction, if a transaction gives rise to deductible and taxable temporary differences of unequal amount, the amendment to the scope of the IRE applies to the portion of the deductible and taxable temporary difference

that is equal (i.e. this portion of the temporary differences is not eligible to the IRE) but the excess (the net temporary difference) may be subject to the IRE. If this second explanation of the conclusion is correct, it should be explained in the amendments proposed to IAS 12 itself. This is because the amendments proposed to IAS 12.15 and IAS 12.24 refer to "equal amounts of taxable and deductible temporary differences" which can reasonably be read to indicate that the overall taxable and the deductible temporary differences on the transaction are equal.

As indicated above, advance lease payments and initial direct costs are examples of the much broader issue of determining whether the IRE applies. Difficulties are also encountered in practice in the following situations (for example)

- Adjustment required to the carrying amount of an already recognised asset or liability. For example, in certain circumstances, IFRS 16 requires a remeasurement of the lease liability with an equal and opposite adjustment to the carrying amount of the right-of-use asset. It would be useful to clarify if and how the proposed amendments would apply in such situations.
- Sales and lease back transactions: depending on whether these are viewed as one or two transactions, the assessment of whether the IRE applies would differ (if viewed as a single transaction that affects accounting profit, the IRE would not apply, if viewed as two transactions, it appears that the IRE would apply to the leaseback with potentially different amounts of taxable and deductible temporary differences).
- Initial recognition of a decommissioning liability with an equal but opposite adjustment to the carrying amount of the related asset, when the asset is immediately subject to an impairment loss. The question that arises in this case is whether the impairment loss is a separate transaction, such that the initial transaction (recognition of the decommissioning liability with an adjustment to the carrying amount of the related asset, without an effect on accounting or taxable profit) is within the scope of the transactions addressed by the proposed amendment or if the transaction is scoped out of the IRE because the resulting impairment loss affects accounting profit at the time of the transaction such that the resulting impact of DTA or DTL is recognised in profit.

The identification of transactions that are subject to the IRE is a fundamental issue that must be addressed in order to reduce diversity in practice.