IAS 12: Deferred Taxes Related to Assets and Liabilities Arising from a Single Transaction

Extract, IFRS® Discussion Group Report on the Meeting – September 21, 2022

The Group discussed the potential implications of the amendments to IAS 12 *Income Taxes*, for *Deferred Taxes Related to Assets and Liabilities Arising from a Single Transaction*, issued in May 2021. The amendments are effective for reporting periods beginning on or after January 1, 2023, with early application permitted.

Certain types of transactions are accounted for by recognizing both an asset and a liability. For example:

- under IFRS 16 *Leases*, a lessee recognizes both a right-of-use asset and a lease liability at the commencement date of a lease; and
- under IAS 16 *Property, Plant and Equipment*, an entity recognizes the initial estimate of a decommissioning obligation in both the cost of the asset and as a provision under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

The general principle in IAS 12 is for entities to recognize deferred tax assets for transactions that result in deductible temporary differences and deferred tax liabilities for transactions that result in taxable temporary differences. There is, however, an exemption to the requirement to recognize deferred taxes when, at the time of the transaction, the transaction affects neither accounting profit nor taxable profit (the "initial recognition exemption").

Depending on the applicable tax law, some transactions may result in equal and offsetting temporary differences. Prior to the issuance of the amendment, there was diversity in practice in terms of applying the initial recognition exemption to such transactions.

As a result, the IASB issued an amendment to IAS 12 to exclude transactions that give rise to equal taxable and deductible temporary differences from the initial recognition exemption. In applying this amendment, entities will be required to recognize these equal and offsetting temporary differences in their financial statements.

The Group discussed the application of this amendment as it applies to a lessee recognizing both a right-of-use asset and a lease liability at the commencement date of a lease.

Issue 1: In Canada, do the tax deductions relate to the asset or liability?

Analysis

Entities should apply judgment to determine whether tax deductions relate to a leased asset (i.e., tax deductions for capital cost allowance) or a lease liability (i.e., tax deductions when an entity makes lease payments) by considering the applicable tax law.

In Canada, lease payments for assets used in an entity's business are normally deducted in the year they are incurred. As a result, under Canadian tax law, tax deductions for a lease often relate to the lease liability.

However, the entity needs to apply judgment to determine this. For example, under certain conditions, and with the agreement of the lessor, a partnership (lessee) may choose to treat lease payments as combined payments of principal and interest. In those cases, the lessee would be considered (for tax purposes) to have purchased the asset by borrowing an amount equal to its fair market value, rather than having leased the asset. The lessee could then deduct the interest portion of the payment as an expense and could also claim capital cost allowance on the asset. The lessee might determine that the tax deductions relate to the leased asset in such a case.

The Group's Discussion

The Group agreed with the analysis.

Some Group members pointed out that many Canadian entities have operations in other jurisdictions subject to different tax laws. These entities should review the wording in the applicable tax law in each jurisdiction where they operate and apply judgment to determine whether the tax deductions relate to the leased asset or the lease liability.

Issue 2: How does the allocation of tax deductions to either the asset or the liability affect the determination of temporary differences on initial recognition?

Analysis

Tax deductions related to the leased asset

When the tax deductions relate to the leased asset, the tax bases of the leased asset and lease liability are equal to the carrying amount of the leased asset and lease liability, respectively. As a result, no temporary differences arise on initial recognition of the lease and the initial recognition exemption does not apply.

The lessee would not recognize any deferred taxes on initial recognition because there are no temporary differences at that time. The lessee will subsequently recognize deferred taxes if temporary differences arise after initial recognition.

Tax deductions related to the lease liability

When the tax deductions relate to the lease liability, the tax bases of both the leased asset and lease liability are zero. As a result, a taxable temporary difference with respect to the leased asset and a deductible temporary difference with respect to the lease liability arise.

Under the amendments to IAS 12, the initial recognition exemption would not apply to the extent that the taxable and deductible temporary differences are equal. The lessee would therefore recognize both a deferred tax asset and deferred tax liability on initial recognition of the lease transaction.

The Group's Discussion

The Group agreed with the analysis.

Some Group members pointed out that the purpose of the amendment is to eliminate diversity in practice. Therefore, some entities will not need to change practice if they already do not apply the initial recognition exemption to deferred taxes related to assets and liabilities arising from a single transaction. One Group member noted that entities that change practice as a result of this amendment should consider the additional disclosure requirements related to deferred taxes under IAS 12.

One Group member noted that entities might need to present the offsetting deferred tax asset and deferred tax liability as a net balance on their balance sheet. Paragraphs 74-75 of IAS 12 provide guidance on when deferred tax assets and liabilities should be offset for presentation purposes.

Another Group member noted that the outcome of applying the amendment is a consistent effective income tax rate, whether the lease payments relate to the leased asset or lease liability.

Some Group members commented that some lease agreements include advance lease payments and other initial direct costs. These Group members indicated that entities should account for the deferred tax impact of these payments.

Issue 3: If the entity does not recognize a deferred tax asset on initial recognition of the transaction because of the recoverability requirement in IAS 12, does this impact the recognition of any deferred tax liability?

Analysis

Paragraph 24 of IAS 12 only allows an entity to recognize deferred tax assets "to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilized" (i.e., the "recoverability requirement"). Therefore, this might result in an entity recognizing unequal deferred tax assets and liabilities even if the taxable and deductible temporary differences are equal.

An entity should continue to recognize a deferred tax liability for all of the taxable temporary differences that arise on initial recognition of the transaction. In accordance with paragraph 22(b) of IAS 12, any difference from the offsetting deferred tax asset should be recognized in profit or loss as a deferred tax expense. At the end of each reporting period, the lessee would need to reassess any unrecognized deferred tax assets that were not recognized as a result of the recoverability requirement.

The Group's Discussion

The Group agreed with the analysis.

Issue 4: What are the next steps for transition?

Analysis

For most types of transactions, entities should apply the amendments to transactions that occur on or after the beginning of the earliest comparative period. For leases and decommissioning obligations, an entity must apply the amendments for the first time by recognizing deferred tax for all temporary differences at the beginning of the earliest comparative period presented. These transition requirements also apply to first-time adopters at the date of their transition to IFRS Accounting Standards.

The Group's Discussion

The Group agreed with the analysis.

Overall, the Group's discussion raised awareness of the potential implications of the amendments to IAS 12 for deferred taxes related to assets and liabilities arising from a single transaction. No further action was recommended to the AcSB.