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- **Volume A** contains the core Standard and the IASB’s Board Approvals;
- **Volume B** contains Illustrative Examples and Implementation Guidance; and
- **Volume C** contains Basis for Conclusions and Dissenting Opinions.

Accordingly, this combined document may include references to “*this volume*”, *Part A, B or C*, or “*this edition*”. Any page references relate to the IASB’s published suite of Standards, not to this combined document.

The wording of the core Standard as issued by the IASB is not reproduced in this document.

IAS 12

**Approval by the Board of *Deferred Tax: Recovery of Underlying Assets* (Amendments to IAS 12) issued in December 2010**

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*Deferred Tax: Recovery of Underlying Assets* (Amendments to IAS 12) was approved for publication by the fifteen members of the International Accounting Standards Board.

Sir David Tweedie Chairman

Stephen Cooper

Philippe Danjou

Jan Engström

Patrick Finnegan

Amaro Luiz de Oliveira Gomes

Prabhakar Kalavacherla

Elke König

Patricia McConnell

Warren J McGregor

Paul Pacter

Darrel Scott

John T Smith

Tatsumi Yamada

Wei-Guo Zhang

**Approval by the Board of *Recognition of Deferred Tax Assets for Unrealised Losses* (Amendments to IAS 12) issued in January 2016**

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*Recognition of Deferred Tax Assets for Unrealised Losses* was approved for issue by the fourteen members of the International Accounting Standards Board.

Hans Hoogervorst	Chairman
Ian Mackintosh	Vice-Chairman
Stephen Cooper	
Philippe Danjou	
Martin Edelmann	
Patrick Finnegan	
Amaro Gomes	
Gary Kabureck	
Suzanne Lloyd	
Takatsugu Ochi	
Darrel Scott	
Chungwoo Suh	
Mary Tokar	
Wei-Guo Zhang	

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**Approval by the Board of *Deferred Tax related to Assets and Liabilities arising from a Single Transaction* issued in May 2021**

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*Deferred Tax related to Assets and Liabilities arising from a Single Transaction*, which amended IAS 12, was approved for issue by all 13 members of the International Accounting Standards Board.

Hans Hoogervorst Chairman

Suzanne Lloyd Vice-Chair

Nick Anderson

Tadeu Cendon

Martin Edelmann

Françoise Flores

Zach Gast

Jianqiao Lu

Bruce Mackenzie

Thomas Scott

Rika Suzuki

Ann Tarca

Mary Tokar

**Approval by the IASB of *International Tax Reform—Pillar Two Model Rules* issued in May 2023**

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*International Tax Reform—Pillar Two Model Rules*, which amended IAS 12, was approved for issue by 13 of the 14 members of the International Accounting Standards Board. Mr Gast dissented. His dissenting opinion is set out after the Basis for Conclusions.

Andreas Barckow	Chair
Linda Mezon-Hutter	Vice-Chair
Nick Anderson	
Patrina Buchanan	
Tadeu Cendon	
Florian Esterer	
Zach Gast	
Hagit Keren	
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Ann Tarca	
Robert Uhl	

**IASB documents published to accompany**

**IAS 12**

# Income Taxes

The text of the unaccompanied standard, IAS 12, is contained in Part A of this edition. Its effective date when issued was 1 January 1998. The text of the Accompanying Guidance on IAS 12 is contained in Part B of this edition. This part presents the following document:

**BASIS FOR CONCLUSIONS**

**DISSENTING OPINION**

## **Basis for Conclusions on IAS 12 *Income Taxes***

*This Basis for Conclusions accompanies, but is not part of, IAS 12.*

### **Introduction**

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- BC1 When IAS 12 *Income Taxes* was issued by the International Accounting Standards Committee in 1996 to replace the previous IAS 12 *Accounting for Taxes on Income* (issued in July 1979), the Standard was not accompanied by a Basis for Conclusions. This Basis for Conclusions is not comprehensive. It summarises only the considerations of the International Accounting Standards Board (Board) in developing amendments to IAS 12 since 2010. Individual Board members gave greater weight to some factors than to others.
- BC1A In August 2014 the Board published an Exposure Draft of proposed amendments to IAS 12 to clarify the requirements on recognition of deferred tax assets for unrealised losses on debt instruments measured at fair value. The Board subsequently modified and confirmed the proposals and in January 2016 issued *Recognition of Deferred Tax Assets for Unrealised Losses (Amendments to IAS 12)*. The Board's considerations and reasons for its conclusions are discussed in paragraphs BC37–BC62.
- BC2 The Board amended IAS 12 to address an issue that arises when entities apply the measurement principle in IAS 12 to temporary differences relating to investment properties that are measured using the fair value model in IAS 40 *Investment Property*.
- BC3 In March 2009 the Board published an exposure draft, *Income Tax* (the 2009 exposure draft), proposing a new IFRS to replace IAS 12. In the 2009 exposure draft, the Board addressed this issue as part of a broad proposal relating to the determination of tax basis. In October 2009 the Board decided not to proceed with the proposals in the 2009 exposure draft and announced that, together with the US Financial Accounting Standards Board, it aimed to conduct a fundamental review of the accounting for income tax in the future. In the meantime, the Board would address specific significant current practice issues.
- BC4 In September 2010 the Board published proposals for addressing one of those practice issues in an exposure draft *Deferred Tax: Recovery of Underlying Assets* with a 60-day comment period. Although that is shorter than the Board's normal 120-day comment period, the Board concluded that this was justified because the amendments were straightforward and the exposure draft was short. In addition, the amendments were addressing a problem that existed in practice and needed to be solved as soon as possible. The Board considered the comments it received on the exposure draft and in December 2010 issued the amendments to IAS 12. The Board intends to address other practice issues arising from IAS 12 in due course, when other priorities on its agenda permit this.

## Recovery of revalued non-depreciable assets

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- BC5 In December 2010, the Board incorporated in paragraph 51B of IAS 12 the consensus previously contained in SIC Interpretation 21 *Income Taxes – Recovery of Revalued Non-Depreciable Assets*. However, because paragraph 51C addresses investment property carried at fair value, the Board excluded such assets from the scope of paragraph 51B. Paragraphs BC6 and BC7 set out the basis that the Standing Interpretations Committee (SIC) gave for the conclusions it reached in developing the consensus expressed in SIC-21.
- BC6 The SIC noted that the *Framework for the Preparation and Presentation of Financial Statements*<sup>1</sup> stated that an entity recognises an asset if it is probable that the future economic benefits associated with the asset will flow to the entity. Generally, those future economic benefits will be derived (and therefore the carrying amount of an asset will be recovered) through sale, through use, or through use and subsequent sale. Recognition of depreciation implies that the carrying amount of a depreciable asset is expected to be recovered through use to the extent of its depreciable amount, and through sale at its residual value. Consistently with this, the carrying amount of a non-depreciable asset, such as land having an unlimited life, will be recovered only through sale. In other words, because the asset is not depreciated, no part of its carrying amount is expected to be recovered (ie consumed) through use. Deferred taxes associated with the non-depreciable asset reflect the tax consequences of selling the asset.
- BC7 The SIC noted that the expected manner of recovery is not predicated on the basis of measuring the carrying amount of the asset. For example, if the carrying amount of a non-depreciable asset is measured at its value in use, the basis of measurement does not imply that the carrying amount of the asset is expected to be recovered through use, but through its residual value upon ultimate disposal.

## Recovery of investment properties

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### Reason for the exception

- BC8 IAS 12 applies the principle that the measurement of deferred tax liabilities and deferred tax assets should reflect the tax consequences that would follow from the manner in which the entity expects to recover or settle the carrying amount of its assets and liabilities. In many cases, however, an entity expects to rent out investment property to earn rental income and then sell it to gain from capital appreciation at some point in the future. Without specific plans for disposal of the investment property, it is difficult and subjective to estimate how much of the carrying amount of the investment property will be recovered through cash flows from rental income and how much of it will be recovered through cash flows from selling the asset.

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<sup>1</sup> The reference is to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the Board in 2001 and in effect when the SIC discussed this matter.

## IAS 12 BC

- BC9 It is particularly difficult and subjective to determine the entity's expected manner of recovery for investment property that is measured using the fair value model in IAS 40. In contrast, for investment property that is measured using the cost model in IAS 40, the Board believes that the estimates required for depreciation establish the expected manner of recovery because there is a general presumption that an asset's carrying amount is recovered through use to the extent of the amount subject to depreciation and through sale to the extent of the residual value.
- BC10 To address this issue, the Board introduced an exception to the principle in IAS 12 that applies when an entity adopts an accounting policy of remeasuring investment property at fair value. The purpose of the exception is to reflect the entity's expectation of recovery of the investment property in a practical manner that involves little subjectivity.
- BC11 Many respondents to the exposure draft of September 2010 commented that the Board should develop application guidance rather than creating an exception. The Board could have achieved a similar result in some cases by providing application guidance on how to apply the underlying principle to investment property. However, the Board chose an exception because it is simple, straightforward and can avoid unintended consequences by a strict definition of its scope. In fact, this exception is very similar to application guidance. However, it is technically an exception because, in some cases, the asset's carrying amount is assumed to be recovered entirely through sale even though an entity expects it to be recovered partly through sale and partly through use.
- BC12 The Board also noted that application guidance would not resolve a practice issue that arises when the future income generated from an asset is expected to exceed the carrying amount of that asset and that future income will be subject to two or more different tax regimes. In those situations, IAS 12 provides no basis for determining which tax rate and tax base apply to the recovery of the carrying amount. The Board concluded that the practical way to resolve this issue was to create an exception that determines the manner of recovery of an asset within the scope of that exception.

### **Scope of the exception**

- BC13 The Board understands that the concerns raised in practice relate primarily to investment property measured using the fair value model in IAS 40. The Board proposed in the exposure draft that the exception should also apply to property, plant and equipment or intangible assets measured using the revaluation model in IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets*. That was because in assessing the difficulty and subjectivity involved in determining the expected manner of recovering the carrying amount of the underlying asset, there is no underlying difference between regularly fair valuing assets through a revaluation accounting policy and applying a fair value measurement model.

- BC14 Many respondents disagreed with the proposal to include property, plant and equipment or intangible assets measured using the revaluation model in IAS 16 or IAS 38 in the scope of the exception. They stated that many items of property, plant and equipment are recovered through use rather than through sale, and that this is consistent with the definition of property, plant and equipment in IAS 16. In addition, many respondents disagreed with the presumption of recovery through sale when the underlying assets are intangible assets for similar reasons. They also warned of unintended consequences that could arise because of the varying nature of intangible assets. Many respondents suggested limiting the scope of the exception to investment properties measured using the fair value model in IAS 40. Having considered those comments, the Board adopted that suggestion.
- BC15 Some respondents supported inclusion of property, plant and equipment in the scope of the exception, including property, plant and equipment measured on a cost basis, because of their concerns about the lack of discounting deferred tax assets and deferred tax liabilities and about a possible double-counting of tax effects (see paragraph BC19). However, the Board concluded that considering concerns about the lack of discounting and about the possible double-counting was outside the limited scope of the amendments.
- BC16 The Board made it clear that the exception also applies on initial measurement of investment property acquired in a business combination if the investment property will subsequently be measured using the fair value model in IAS 40. If the exception did not apply in these circumstances, deferred taxes might reflect the tax consequences of use at the acquisition date, but at a later date reflect the tax consequences of sale. The Board believes that measurement of deferred taxes at the acquisition date should be consistent with the subsequent measurement of the same deferred taxes. For the same reason, the Board concluded that the exception should not apply to investment property initially measured at fair value in a business combination if the entity subsequently uses the cost model.
- BC17 Having considered the responses to the exposure draft, the Board decided not to extend the exception to other underlying assets and liabilities that are measured at fair value, including financial instruments or biological assets. This is because the Board understands that the most significant current practice issues relate to investment property. In addition, the Board wished to avoid unintended consequences of expanding the scope to other assets and liabilities that are measured on a fair value basis.
- BC18 The Board concluded that the amendments should apply to all temporary differences that arise relating to underlying assets within the scope of the exception, not just those separate temporary differences created by the remeasurement of the underlying asset. This is because the unit of account applied in determining the manner of recovery in the Standard is the underlying asset as a whole, not the individual temporary differences.

### **Measurement basis**

- BC19 The Board decided that when the exception applies, there should be a presumption that deferred taxes should be measured to reflect the tax consequences of recovering the carrying amount of the investment property entirely through sale. In making that decision, the Board considered various views expressed by interested parties, which included, but were not limited to the following:
- (a) the tax effect would be double-counted in some situations if deferred taxes are measured on the basis of the tax consequences of use, because the investment property is measured at fair value, which reflects some of these tax consequences; and
  - (b) presuming sale is consistent with a fair value measurement basis that reflects the price that would be received if the investment property is sold.
- BC20 Many respondents to the exposure draft said that choosing a measurement basis of fair value is an accounting policy choice that does not imply or predict recovery of the investment property through sale. Many also said that the proposed exception would solve the double-counting problem partially but not completely. The Board noted that the aim of the exception was neither to link the accounting policy with measurement of deferred taxes (see paragraph BC7), nor to remove completely the double-counting of tax effects (see paragraph BC15). The aim of this exception is to provide a practical approach when determination of the expected manner of recovery is difficult and subjective.
- BC21 In many cases when an entity chooses the fair value model for investment property, investment properties are recovered through sale. Even if an investment property earns income through rental use in a given period, the value of the future earnings capacity of the investment property will often not decrease and that value will ultimately be realised through sale. Therefore, the Board retained its proposal to introduce a presumption of recovery through sale.
- BC22 The Board made that presumption rebuttable because the Board believes that it is not always appropriate to assume the recovery of investment property through sale. The Board initially proposed in the exposure draft that the presumption of recovery through sale is not appropriate when the entity has clear evidence that it will consume the asset's economic benefits throughout its economic life. The Board set a criterion that refers to consumption of the asset's economic benefits, rather than to the recovery of the carrying amount, because the Board understands that there is diverse practice regarding the meaning of the recovery of the carrying amount through use or through sale.
- BC23 After considering the responses to the exposure draft, the Board reworded the rebuttable presumption so that clear evidence would not be required to rebut it. Instead, the presumption is rebutted if an asset is held within a business model whose objective is to consume substantially all of the economic benefits embodied in the investment property over time, rather than through sale.

Many respondents were concerned that, because clear evidence is an ambiguous term, the requirement to gather clear evidence would have been onerous for entities that have no problem applying the existing principle in IAS 12, and could have led to abuse by entities that choose whether to gather clear evidence to achieve a favourable result. The Board chose to use the term 'business model' because it is already used in IFRS 9 *Financial Instruments* and would not depend on management's intentions for an individual asset. Many respondents were concerned that the presumption would lead to inappropriate results in some cases because it would not be rebutted if a minor scrap value would be recovered through sale. The Board also reworded the rebuttable presumption in order to respond to those concerns. The Board also made it clear that the presumption of recovery through sale cannot be rebutted if the asset is non-depreciable because that fact implies that no part of the carrying amount of the asset would be consumed through use (see paragraph BC6).

- BC24 The Board also considered other approaches to the measurement of deferred tax liabilities and deferred tax assets when the exception applies, specifically whether deferred taxes should be measured on the basis of the lower of the tax consequences of recovery through use and through sale. However, the Board rejected such an approach, noting that it would have created:
- (a) conceptual and practical concerns about whether deferred tax assets should be measured to reflect the lower of, or higher of, the tax consequences of use and of sale;
  - (b) a measurement basis that some believe would be arbitrary; and
  - (c) concerns that entities might be required to measure deferred taxes on a basis that is inconsistent with their expectations of recovery of the carrying amount of the underlying asset.
- BC25 Some respondents to the exposure draft drew the mistaken conclusion that the exposure draft required presumption of *immediate* sale at the end of the reporting period when assessing the presumption of recovery through sale. The Board observed that paragraph 47 of IAS 12 requires deferred tax assets and liabilities to be measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled on the basis of tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period. This requirement applies even when the presumption of recovery through sale is used. For clarification, the Board adjusted the illustrative example following paragraph 51C to reflect the requirement in paragraph 47.
- BC26 In the exposure draft, the Board proposed to withdraw SIC-21. However, many respondents commented that SIC-21 should be retained in order to avoid unintended consequences. Having considered the responses to the exposure draft, the Board decided to incorporate SIC-21 into IAS 12 in its entirety after excluding from the scope of SIC-21 the investment property subject to the requirement in paragraph 51C.

### Assessment of deferred tax assets

BC27 The Board inserted paragraph 51E to confirm that the requirements in paragraphs 24–33 (deductible temporary differences) and paragraphs 34–36 (unused tax losses and unused tax credits) relating to assessment of deferred tax assets continue to apply even when the presumption of recovery through sale arises. The Board did not think that additional guidance would be necessary.

### Disclosure requirement

BC28 The Board proposed in the exposure draft disclosure of the fact of, and reasons for, the rebuttal of the presumption of recovery through sale if the entity has rebutted the presumption. However, many respondents said that this disclosure would add little or no value to the financial statements. IAS 1 *Presentation of Financial Statements* already requires disclosures regarding material judgements.<sup>2</sup> Thus, there is no need to disclose a particular judgement on specific types of assets. The Board was convinced by those arguments and did not proceed with the proposed disclosure requirement.

## The costs and benefits of the amendments to IAS 12

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BC29 Computation of the tax consequences of selling assets is complex in some tax jurisdictions and there are concerns that the amendments to IAS 12 will increase the administrative burden for some entities in those tax jurisdictions.

BC30 However, the Board believes that the benefit of providing the exception outweighs this potential increase in administrative burden for some entities. This is because the purpose of the exception is to enable preparers to measure deferred taxes in these circumstances in the least subjective manner and in so doing enhance the comparability of financial information about deferred taxes for the benefit of users of financial statements. It is also expected to result in an overall reduction of the administrative burden for entities that have previously had to consider the tax consequence of both use and sale of an investment property when measuring deferred taxes.

BC31 Many respondents to the exposure draft said that entities would not benefit from the amendments in jurisdictions in which this practice issue did not exist but would suffer from an increased administrative burden as a result of the amendments. Their criticism mainly focused on the rebuttable presumption, as discussed in paragraphs BC22 and BC23. They also said that the disclosure requirement proposed in the exposure draft would be onerous.

BC32 After considering the responses to the exposure draft, the Board narrowed the scope of the exception to apply only to investment property carried at fair value. It reworded the rebuttable presumption so that clear evidence would no longer be required to rebut the presumption. The Board also did not pursue the proposed disclosure requirement regarding the fact of, and reason for, the rebuttal. After those changes, the Board believes that the amendments will

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<sup>2</sup> In April 2024 the IASB issued IFRS 18 *Presentation and Disclosure in Financial Statements* and carried over the definition of ‘material’ from IAS 1 *Presentation of Financial Statements* to IFRS 18.

not be onerous for entities that have previously been able to establish without difficulty how they expect to recover investment property carried at fair value.

### Transition and effective date

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- BC33 IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*<sup>3</sup> requires an entity to apply retrospectively a change in accounting policy resulting from the initial application of an IFRS that does not have a transition provision. The Board did not include any transition provision in the amendments because, in the Board's view, it would not be unduly burdensome for entities to apply the changes to IAS 12 retrospectively.
- BC34 The Board acknowledges that the amendments may add some administrative burden if they apply to investment property acquired in a business combination that occurred in a previous reporting period. For example, it could be difficult to restate goodwill and recalculate previous impairment reassessments if some information is not available and an entity is unable to separate the effects of hindsight. However, the Board reasoned that the amendments apply only to specific circumstances. Moreover, IAS 8 provides sufficient guidance to deal with cases when it might be impracticable to reassess impairment of goodwill or recoverability of deferred tax assets.
- BC35 Consequently, the Board concluded that the cost of requiring retrospective application is outweighed by the benefit of consistent application of the amendments by entities to all periods presented in the financial statements. Accordingly, the Board decided that entities should apply the amendments to IAS 12 retrospectively in accordance with IAS 8.

### First-time adoption of IFRSs

- BC36 The Board identified no reason to adjust the exception for application by a first-time adopter at its date of transition to IFRSs.

### ***Recognition of Deferred Tax Assets for Unrealised Losses (2016 amendments)***

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- BC37 The IFRS Interpretations Committee (the 'Interpretations Committee') was asked to provide guidance on how an entity determines, in accordance with IAS 12, whether to recognise a deferred tax asset when:
- (a) the entity has a debt instrument that is classified as an available-for-sale financial asset in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*.<sup>4</sup> Changes in the market interest rate result in a decrease in the fair value of the debt instrument to below its cost (ie it has an 'unrealised loss');

<sup>3</sup> When it issued IFRS 18, the IASB changed the title of IAS 8 to *Basis of Preparation of Financial Statements*.

<sup>4</sup> IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39. Under IFRS 9, the same question arises for debt instruments measured at fair value.

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- (b) it is probable that the issuer of the debt instrument will make all the contractual payments;
- (c) the tax base of the debt instrument is cost;
- (d) tax law does not allow a loss to be deducted on a debt instrument until the loss is realised for tax purposes;
- (e) the entity has the ability and intention to hold the debt instrument until the unrealised loss reverses (which may be at its maturity);
- (f) tax law distinguishes between capital gains and losses and ordinary income and losses. While capital losses can only be offset against capital gains, ordinary losses can be offset against both capital gains and ordinary income; and
- (g) the entity has insufficient taxable temporary differences and no other probable taxable profits against which the entity can utilise deductible temporary differences.

BC38 The Interpretations Committee reported to the Board that practice differed because of divergent views on the following questions:

- (a) Do decreases in the carrying amount of a fixed-rate debt instrument for which the principal is paid on maturity always give rise to a deductible temporary difference if this debt instrument is measured at fair value and if its tax base remains at cost? In particular, do they give rise to a deductible temporary difference if the debt instrument's holder expects to recover the carrying amount of the asset by use, ie continuing to hold it, and if it is probable that the issuer will pay all the contractual cash flows? (see paragraphs BC39–BC45)
- (b) Does an entity assume that it will recover an asset for more than its carrying amount when estimating probable future taxable profit against which deductible temporary differences are assessed for utilisation if such recovery is probable? This question is relevant when taxable profit from other sources is insufficient for the utilisation of the deductible temporary differences related to debt instruments measured at fair value. In this case, an entity may only be able to recognise deferred tax assets for its deductible temporary differences if it is probable that it will collect the entire cash flows from the debt instrument and therefore recover it for more than its carrying amount. (see paragraphs BC46–BC54)
- (c) When an entity assesses whether it can utilise deductible temporary differences against probable future taxable profit, does that probable future taxable profit include the effects of reversing deductible temporary differences? (see paragraphs BC55–BC56)
- (d) Does an entity assess whether a deferred tax asset is recognised for each deductible temporary difference separately or in combination with other deductible temporary differences? This question is relevant, for example, when tax law distinguishes capital gains and losses from

other taxable gains and losses and capital losses can only be offset against capital gains. (see paragraphs BC57–BC59)

### **Existence of a deductible temporary difference**

- BC39 In the case of many debt instruments, the collection of the principal on maturity does not increase or decrease taxable profit that is reported for tax purposes. This is the case in the example illustrating paragraph 26(d) of IAS 12. Interest is paid at the contractual rate each year, and on maturity of the debt instrument the issuer pays the principal of CU1,000. In this example, if the investor continues to hold the debt instrument, the investor only pays taxes on the interest income. The collection of the principal does not trigger any tax payments.
- BC40 Because the collection of the principal does not increase or decrease the taxable profit that is reported for tax purposes, some thought that the collection of the principal is a non-taxable event. Sometimes, tax law does not explicitly address whether the collection of the principal has tax consequences. Consequently, proponents of this view thought that a difference between the carrying amount of the debt instrument in the statement of financial position and its higher tax base does not give rise to a deductible temporary difference, if this difference results from a loss that they expect will not be realised for tax purposes.
- BC41 Those who held this view thought that the loss would not be realised for tax purposes if the entity has the ability and intention to hold the debt instrument over the period until the loss reverses, which might be until maturity, and it is probable that the entity will receive all the contractual cash flows. In this case, differences between the carrying amount of the debt instrument in the statement of financial position and its tax base reverse over the period to maturity, as a result of continuing to hold the debt instrument.
- BC42 The Board considered the guidance in IAS 12 on the identification of temporary differences and rejected the reasoning presented in paragraphs BC40 and BC41. Paragraphs 20 and 26(d) of IAS 12 specify that a difference between the carrying amount of an asset measured at fair value and its higher tax base gives rise to a deductible temporary difference. This is because the calculation of a temporary difference in IAS 12 is based on the premise that the entity will recover the carrying amount of an asset, and hence economic benefits will flow to the entity in future periods to the extent of the asset's carrying amount at the end of the reporting period. In contrast, the view presented in paragraphs BC40 and BC41 is based on the assessment of the economic benefits that are expected at maturity. The Board noted that the existence of a deductible temporary difference depends solely on a comparison of the carrying amount of an asset and its tax base at the end of the reporting period, and is not affected by possible future changes in the carrying amount.
- BC43 Consequently, the Board concluded that decreases below cost in the carrying amount of a fixed-rate debt instrument measured at fair value for which the tax base remains at cost give rise to a deductible temporary difference. This applies irrespective of whether the debt instrument's holder expects to

recover the carrying amount of the debt instrument by sale or by use, ie continuing to hold it, or whether it is probable that the issuer will pay all the contractual cash flows. Normally, the collection of the entire principal does not increase or decrease taxable profit that is reported for tax purposes, because the tax base equals the inflow of taxable economic benefits when the principal is paid. Typically, the tax base of the debt instrument is deducted either on sale or on maturity.

- BC44 The economic benefit embodied in the related deferred tax asset arises from the ability of the holder of the debt instrument to achieve future taxable gains in the amount of the deductible temporary difference without paying taxes on those gains. In contrast, an entity that acquires the debt instrument described in the example illustrating paragraph 26(d) of IAS 12 for its fair value at the end of Year 2 (in the example, CU918) and continues to hold it, has to pay taxes on a gain of CU82, whereas the entity in that example will not pay any taxes on the collection of the CU1,000 of principal. The Board concluded that it was appropriate for the different tax consequences for these two holders of the same instrument to be reflected in the deferred tax accounting for the debt instrument.
- BC45 The Board has added an example after paragraph 26 of IAS 12 to illustrate the identification of a deductible temporary difference in the case of a fixed-rate debt instrument measured at fair value for which the principal is paid on maturity.

### **Recovering an asset for more than its carrying amount**

- BC46 The Board noted that paragraph 29 of IAS 12 identifies taxable profit in future periods as one source of taxable profits against which an entity can utilise deductible temporary differences. Future taxable profit has to be probable to justify the recognition of deferred tax assets.
- BC47 The guidance in paragraph 29 of IAS 12 does not refer to the carrying amount of assets within the context of estimating probable future taxable profit. Some thought, however, that the carrying amount of an asset to which a temporary difference is related limits the estimate of future taxable profit. They argued that accounting for deferred taxes should be based on consistent assumptions, which implies that an entity cannot assume that, for one and the same asset, the entity will recover it:
- (a) for its carrying amount when determining deductible temporary differences and taxable temporary differences; as well as
  - (b) for more than its carrying amount when estimating probable future taxable profit against which deductible temporary differences are assessed for utilisation.
- BC48 Consequently, proponents of this view thought that an entity cannot assume that it will collect the entire principal of CU1,000 in the example illustrating paragraph 26(d) of IAS 12 when determining probable future taxable profit. Instead, they thought that an entity must assume that it will collect only the carrying amount of the asset.

- BC49 The Board noted however that determining temporary differences and estimating probable future taxable profit against which deductible temporary differences are assessed for utilisation are two separate steps and the carrying amount of an asset is relevant only to determining temporary differences. The carrying amount of an asset does not limit the estimation of probable future taxable profit. In its estimate of probable future taxable profit, an entity includes the probable inflow of taxable economic benefits that results from recovering an asset. This probable inflow of taxable economic benefits may exceed the carrying amount of the asset.
- BC50 Moreover, a limitation on the estimate of probable future taxable profit by the carrying amount of assets can lead to inappropriate results in other scenarios. For example, a significant part of the assets of a profitable manufacturing entity is property, plant and equipment and inventories. Property, plant and equipment may be measured using the cost model (paragraph 30 of IAS 16 *Property, Plant and Equipment*) and inventories are measured at the lower of cost and net realisable value (paragraph 9 of IAS 2 *Inventories*). If such an entity expects to generate future taxable profit, it may be inconsistent to assume that it will only recover these assets for their carrying amount. This is because a significant part of the manufacturing entity's probable future taxable profit results from using those assets to generate taxable profit in excess of their carrying amount.
- BC51 If a limitation such as the one described in paragraph BC50 was made, then, for the purpose of consistency, the entity would need to assume that it will not recover any of its assets for more than their carrying amount. The Board decided that it would not be appropriate to limit the estimate of probable future taxable profit to the carrying amount of related assets only for assets to which temporary differences are related, because there is no basis for a different assessment that would depend on whether a deductible temporary difference is related to an asset or not.
- BC52 Some respondents to the Exposure Draft expressed concern that the guidance might be applied more broadly, and in their view, inappropriately, to other assets, and not merely to debt instruments measured at fair value. Some other respondents were concerned that any guidance would give the false impression that future taxable profit should be estimated on an individual asset basis. The Board noted that the principle that the estimate of probable future taxable profit includes an expected recovery of assets for more than their carrying amounts is not limited to any specific type or class of assets.
- BC53 However, the Board also noted that there are cases in which it may not be probable that an asset will be recovered for more than its carrying amount. An entity should not inappropriately assume that an asset will be recovered for more than its carrying amount. The Board thought that this is particularly important when the asset is measured at fair value. In response to that concern, the Board noted that entities will need to have sufficient evidence on which to base their estimate of probable future taxable profit, including when that estimate involves the recovery of an asset for more than its carrying amount. For example, in the case of a fixed-rate debt instrument measured at fair value, the entity may judge that the contractual nature of future cash

flows, as well as the assessment of the likelihood that those contractual cash flows will be received, adequately supports the conclusion that it is probable that it will recover the fixed-rate debt instrument for more than its carrying amount, if the expected cash flows exceed the debt instrument's carrying amount. The Board thought that such an example could enhance understanding and reduce the risk of arbitrary estimates of future taxable profit.

- BC54 The Board has added paragraph 29A to IAS 12 to clarify to what extent an entity's estimate of future taxable profit (paragraph 29) includes amounts from recovering assets for more than their carrying amounts.

### **Probable future taxable profit against which deductible temporary differences are assessed for utilisation**

- BC55 The Interpretations Committee observed that there is uncertainty about how to determine probable future taxable profit against which deductible temporary differences are assessed for utilisation when this profit is being assessed to determine the recognition of all deferred tax assets. The uncertainty relates to whether the probable future taxable profit should include or exclude deductions that will arise when those deductible temporary differences reverse.

- BC56 The Board noted that deductible temporary differences are utilised by deduction against taxable profit, excluding deductions arising from reversal of those deductible temporary differences. Consequently, taxable profit used for assessing the utilisation of deductible temporary differences is different from taxable profit on which income taxes are payable, as defined in paragraph 5 of IAS 12. If those deductions were not excluded, then they would be counted twice. The Board has amended paragraph 29(a) to clarify this.

### **Combined versus separate assessment**

- BC57 The Board considered the guidance in IAS 12 on the recognition of deferred tax assets. Paragraph 24 of IAS 12 requires deferred tax assets to be recognised only to the extent of probable future taxable profit against which the deductible temporary differences can be utilised. Paragraph 27 explains that:

- (a) the deductible temporary differences are utilised when their reversal results in deductions that are offset against taxable profits of future periods; and
- (b) economic benefits in the form of reductions in tax payments will flow to the entity only if it earns sufficient taxable profits against which the deductions can be offset.

- BC58 The Board noted that:
- (a) tax law determines which deductions are offset against taxable income in determining taxable profits. The Board also noted that paragraph 5 of IAS 12 defines taxable profit as the profit of a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable.

- (b) no deferred tax asset is recognised if the reversal of the deductible temporary difference will not lead to tax deductions.

BC59 Consequently, if tax law offsets a deduction against taxable income on an entity basis, without segregating deductions from different sources, an entity carries out a combined assessment of all its deductible temporary differences relating to the same taxation authority and the same taxable entity. However, if tax law offsets specific types of losses only against a particular type, or types, of income (for example, if tax law limits the offset of capital losses to capital gains), an entity assesses a deductible temporary difference in combination with other deductible temporary differences of that type(s), but separately from other deductible temporary differences. Segregating deductible temporary differences in accordance with tax law and assessing them on such a basis is necessary to determine whether taxable profits are sufficient to utilise deductible temporary differences. The Board has added paragraph 27A to IAS 12 to clarify this.

### Transition

BC60 The Board decided to require the adjustment of comparative information for any earlier periods presented. However, this amendment allows the change in opening equity of the earliest comparative period presented that arises upon the first application of the amendment to be recognised in opening retained earnings (or in another component of equity, as appropriate), without the need to allocate the change between opening retained earnings and other components of equity. This is to avoid undue cost and effort.

BC61 The Board noted that, with the exception of the amounts that would have to be adjusted within equity, the accounting required by these amendments is based on amounts and estimates at the end of the reporting periods. The changes to the accounting are mechanical in nature and so the Board expects that the cost of adjusting comparatives should not exceed the benefits of greater comparability.

BC62 The Board has not added additional transition relief for first-time adopters. This is consistent with the fact that IFRS 1 *First-time Adoption of International Financial Reporting Standards* does not include an exception to, or exemption from, the retrospective application of the requirements in IAS 12.

### Income tax consequences of payments on financial instruments classified as equity (amendments issued in December 2017)

BC63 The Board was asked about the income tax consequences of payments on financial instruments classified as equity; should an entity recognise them in profit or loss, or in equity? In particular, the Board was asked whether the requirements in paragraph 57A (paragraph 52B before the amendments were made) apply only in the circumstances described in paragraph 52A (for example, when there are different tax rates for distributed and undistributed profits), or whether those requirements apply as long as payments on financial instruments classified as equity are distributions of profit.

## IAS 12 BC

- BC64 The Board observed that:
- (a) paragraph 57A describes how an entity accounts for income tax consequences of dividends paid. Dividends are defined in IFRS 9 as ‘distributions of profits to holders of equity instruments in proportion to their holdings of a particular class of capital’.
  - (b) paragraph 57A first requires an entity to link the income tax consequences of dividends to past transactions or events that generated distributable profits. An entity then applies the requirements in paragraph 58 to determine where to recognise those income tax consequences. Applying paragraph 57A, the entity recognises the income tax consequences of dividends according to where it has recognised the past transactions or events that generated distributable profits.
  - (c) the reason for the income tax consequences of dividends should not affect where those income tax consequences are recognised. It does not matter whether such consequences arise, for example, because of different tax rates for distributed and undistributed profits or because of the deductibility of dividends for tax purposes. This is because, in both cases, the income tax consequences arise from the distribution of profits.
  - (d) linking the recognition of the income tax consequences of dividends to how the tax consequences arise (for example, because of different tax rates, rather than because of different tax-deductibility rules) would lead to arbitrary results and a lack of comparability across entities in different tax jurisdictions. Tax jurisdictions choose different methods of imposing tax or providing tax relief. What matters is the resulting tax effect, not the mechanism.
- BC65 Accordingly, the Board concluded that an entity should recognise all income tax consequences of dividends applying the requirements in paragraph 57A. However, the Board also observed that, before those requirements were amended, the requirements in paragraph 57A could be misread to imply that paragraph 57A applied only in the circumstances described in paragraph 52A.
- BC66 Consequently, the Board clarified that the requirements in paragraph 57A apply to all income tax consequences of dividends.
- BC67 The Board noted that the amendments do not suggest that an entity applies paragraph 57A to the income tax consequences of all payments on financial instruments classified as equity. Rather, paragraph 57A applies only when an entity determines payments on such instruments are distributions of profits (ie dividends). An entity may need to apply judgement in making this determination.
- BC68 The Board considered whether to include requirements on how to determine if payments on financial instruments classified as equity are distributions of profits. It decided not to do so for the following reasons:

- (a) including indicators or requirements that distinguish distributions of profits from other distributions goes beyond the scope of the amendments to IAS 12. Any attempt by the Board to define or describe distributions of profits could affect other IFRS Standards and IFRIC Interpretations, and risks unintended consequences.
- (b) the amendments do not change what is and is not a distribution of profits. They simply clarify that the requirements in paragraph 57A apply to all income tax consequences of dividends.

BC69 The Board concluded that finalising the amendments without adding the possible requirements mentioned in paragraph BC68 would nonetheless be beneficial to preparers and users of financial statements. In particular, the amendments would eliminate the potential for inconsistent accounting that resulted from the ambiguity of the scope of the requirements in paragraph 57A that existed before those requirements were amended.

### Transition

BC70 The Board decided that an entity applies the amendments to income tax consequences of dividends recognised on or after the beginning of the earliest comparative period when it first applies the amendments. This is because application of the amendments before that date could affect only components of equity as at the beginning of the earliest comparative period. The Board concluded that entities would have sufficient information to apply the amendments to the income tax consequences of dividends that occur in comparative reporting periods and that applying the amendments in this way will enhance comparability of reporting periods.

### Deferred Tax related to Assets and Liabilities arising from a Single Transaction (2021 amendments)

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- BC71 In May 2021 the Board issued *Deferred Tax related to Assets and Liabilities arising from a Single Transaction*. The amendments narrowed the scope of the recognition exemption in paragraphs 15 and 24 of IAS 12 (recognition exemption) so that it no longer applies to transactions that, on initial recognition, give rise to equal taxable and deductible temporary differences.
- BC72 The amendments were issued in response to a recommendation from the Interpretations Committee. Research conducted by the Interpretations Committee indicated that views differed on whether the recognition exemption applied to transactions, such as leases, that lead to the recognition of an asset and liability. These differing views resulted in entities accounting for deferred tax on such transactions in different ways, reducing comparability between their financial statements.
- BC73 For simplicity, paragraphs BC74–BC91 explain the basis for the amendments using leases as an example. The explanation applies equally to other transactions affected by the amendments, such as decommissioning, restoration and similar liabilities (decommissioning obligations) and the corresponding amounts recognised as part of the cost of the related asset.

## Background

### Temporary differences and the application of the recognition exemption

- BC74 Applying IFRS 16 *Leases*, an entity recognises a right-of-use asset (lease asset) and a lease liability at the commencement date of a lease. On initial recognition of the lease asset and lease liability, an entity assesses whether temporary differences arise in determining whether to recognise deferred tax. In making this assessment, an entity determines the tax bases of the lease asset and lease liability by identifying the amounts attributable to them for tax purposes. In some jurisdictions, an entity may receive tax deductions for lease payments when it makes such payments. In such situations, the entity determines whether those tax deductions are attributable to:
- (a) the lease asset (and interest expense)—because the deductions relate to the expenses arising from the lease (that is, depreciation and interest expense); or
  - (b) the lease liability (and interest expense)—because the deductions relate to the repayment of the lease liability and interest expense.
- BC75 An entity applies judgement in determining whether tax deductions are attributable to the lease asset or lease liability, having considered the applicable tax law.
- BC76 Applying IAS 12, temporary differences arise on initial recognition only when the entity determines that tax deductions are attributable to the lease liability because:
- (a) when tax deductions are attributable to the lease asset, the tax bases of the lease asset and lease liability equal their carrying amounts, reflecting that the entity will receive tax deductions equal to the carrying amount of the lease asset and will receive no tax deductions in respect of the lease liability. Consequently, no temporary differences arise on initial recognition of the lease and the recognition exemption does not apply. Accordingly, the entity does not recognise deferred tax on initial recognition but does so if and when temporary differences arise after initial recognition.
  - (b) when tax deductions are attributable to the lease liability, the tax bases of the lease asset and lease liability are nil, reflecting that the entity will receive tax deductions in respect of the lease liability equal to its carrying amount and will receive no tax deductions on recovering the carrying amount of the lease asset. Consequently, temporary differences associated with the lease asset and lease liability arise on initial recognition of the lease.
- BC77 Before the amendments were issued, views differed on whether the recognition exemption applied to temporary differences that arise in the situation described in paragraph BC76(b). If an entity concluded that the recognition exemption applied, it recognised no deferred tax in respect of the lease (either on initial recognition or subsequently throughout the lease term).

### **Purpose of the recognition exemption**

- BC78 Paragraph 22(c) of IAS 12 explains the purpose of the recognition exemption. If temporary differences arise on initial recognition of an asset or liability in a transaction that is not a business combination and affects neither accounting profit nor taxable profit, an entity would, in the absence of the exemption, recognise the resulting deferred tax liability or asset and adjust the carrying amount of the asset or liability by the same amount. Such adjustments would make the financial statements less transparent and IAS 12, therefore, prohibits the recognition of deferred tax in these circumstances.
- BC79 The Board observed that, when temporary differences arise on initial recognition of a lease asset and lease liability, these temporary differences are often equal and offsetting (that is, the taxable and deductible temporary differences are of the same amount). If the recognition exemption were not applied, an entity would generally recognise a deferred tax asset and liability of the same amount for these temporary differences. The recognition of a deferred tax asset and liability of the same amount would not require an adjustment to the carrying amount of the related lease asset or lease liability; nor would it have any effect on profit or loss. Thus, the outcome the recognition exemption was designed to prevent would not occur in such situations. The Board, therefore, concluded that the recognition exemption is not generally needed if on initial recognition a transaction gives rise to equal taxable and deductible temporary differences.

### **Narrowing the scope of the recognition exemption**

- BC80 In the light of the observations summarised in paragraph BC79, the Board decided to narrow the scope of the recognition exemption so that it does not apply to transactions that, on initial recognition, give rise to equal taxable and deductible temporary differences.
- BC81 The Board considered how this narrower scope of the recognition exemption would apply when an entity does not recognise a deferred tax asset and liability of the same amount for equal taxable and deductible temporary differences. Specifically, an entity could recognise a deferred tax asset and liability of different amounts if it is unable to recognise the deferred tax asset in full (see paragraphs BC82–BC87), or if different tax rates apply to the measurement of each temporary difference (see paragraph BC88).

### **Inability to recognise deferred tax assets**

- BC82 Paragraph 24 of IAS 12 requires an entity to recognise deferred tax assets only 'to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised' (the recoverability requirement). Because of the recoverability requirement, sometimes equal taxable and deductible temporary differences might result in an entity recognising unequal amounts of deferred tax assets and liabilities.

## IAS 12 BC

- BC83 To address this situation, when it exposed draft amendments for comment, the Board proposed that the recognition exemption continue to apply to the extent that an entity would otherwise recognise unequal amounts of deferred tax assets and liabilities (the capping proposal). Applying the capping proposal, an entity would recognise deferred tax assets and liabilities of the same amount and only to the extent that, applying the recoverability requirement, the entity would recognise a deferred tax asset.
- BC84 Feedback on the draft amendments indicated that the capping proposal would be:
- (a) inconsistent with the principles in IAS 12 because the Standard generally requires an entity to recognise a deferred tax liability for all taxable temporary differences; and
  - (b) complex and burdensome to apply.
- BC85 In response to this feedback, the Board removed the capping proposal. The Board concluded that:
- (a) applying the recognition exemption to a deferred tax liability only because an entity is unable to recognise a corresponding deferred tax asset applying the recoverability requirement would be inconsistent with how the recognition exemption is applied in other situations.
  - (b) removing the capping proposal would significantly reduce the complexity of applying the amendments while still achieving their objective (see BC92(a)). In particular, by removing the capping proposal, the Board would:
    - (i) not require an entity to assess the recoverability requirement on initial recognition of each applicable transaction to determine the extent to which a deferred tax liability can be recognised.
    - (ii) simplify the accounting when, on initial recognition, deferred tax assets are not recognised in full. In such cases, had the capping proposal been retained in the amendments, entities would have been required to track separately the portions of temporary differences to which the recognition exemption was applied.
- BC86 Removing the capping proposal might result in an entity recognising unequal amounts of deferred tax assets and liabilities on initial recognition of a transaction. In such cases, an entity would recognise any difference in profit or loss (see paragraph 22(b) of IAS 12). For example, an entity would recognise an income tax loss if, on initial recognition, it recognises a deferred tax liability but is unable to recognise an equal and offsetting deferred tax asset. The Board concluded that this accounting appropriately reflects the entity's expectation that it will be unable to benefit fully from the tax deductions available when it settles the liability, but that it is nonetheless required to make future tax payments as it recovers the asset. As explained in paragraph BC85(a), applying the recognition exemption to the deferred tax liability only

because an entity is unable to recognise a corresponding deferred tax asset would be inconsistent with how the recognition exemption is applied in other situations.

- BC87 Further, the Board expects that unequal amounts of deferred tax assets and liabilities would arise on initial recognition only infrequently, because an entity might often meet the recoverability requirement through the future reversal of taxable temporary differences arising from the same transaction.

#### **Different tax rates apply**

- BC88 An entity might recognise a deferred tax asset and liability of different amounts for equal taxable and deductible temporary differences if different tax rates apply to the measurement of the deferred tax asset and liability. As noted in paragraph BC86, an entity would recognise any difference in profit or loss. The Board concluded that the expected benefits of applying the recognition exemption in these situations would not outweigh the costs because:

- (a) applying the recognition exemption in these situations would be complex because the recognition exemption would apply to only a small portion of the resulting deferred tax; and
- (b) these situations are expected to arise only in a limited number of jurisdictions and the net effect of applying different tax rates will often be immaterial.

### **Other considerations**

#### **Attribution of tax deductions to the lease asset or lease liability**

- BC89 Some respondents to the draft amendments suggested that the Board provide application guidance to help entities assess whether tax deductions are attributable to the lease asset or lease liability (see paragraph BC74). The Board decided not to provide such application guidance because the expected benefits of doing so would not outweigh the costs. The Board concluded that providing such guidance:

- (a) was unnecessary to achieve the objective of the amendments—the amendments will result in entities recognising deferred tax for temporary differences that arise on leases (either on initial recognition or subsequently) regardless of whether tax deductions are attributable to the lease asset or lease liability; and
- (b) could cause unintended consequences—any such guidance could affect how entities, in other situations, consider the applicable tax laws in determining the tax base of assets and liabilities.

#### **Advance lease payments and initial direct costs**

- BC90 Applying IFRS 16, an entity initially measures a lease liability at the present value of the lease payments not paid at the commencement date. An entity's initial measurement of a lease asset includes the initial measurement of the lease liability as well as advance lease payments and initial direct costs.

## IAS 12 BC

BC91 The recognition of the lease liability and the related component of the lease asset's cost may give rise to equal taxable and deductible temporary differences as explained in paragraph BC79. The amendments apply to any such equal taxable and deductible temporary differences that arise. In addition, making advance lease payments or paying initial direct costs could result in additional taxable temporary differences associated with the lease asset, to which an entity would apply the applicable requirements in IAS 12. In response to requests to do so, the Board included an example illustrating the accounting for deferred tax on advance lease payments and initial direct costs.

### Effect analysis

BC92 The Board concluded that the expected benefits of the amendments outweigh the costs because:

- (a) the amendments will reduce diversity in the reporting of transactions such as leases and decommissioning obligations and align the accounting for deferred tax on such transactions with the general principle in IAS 12 of recognising deferred tax for temporary differences; and
- (b) concerns about the costs of applying the draft amendments related mainly to the application of the capping proposal (see paragraph BC84(b)). The Board's decision to remove the capping proposal addressed most of those concerns.

### Transition

BC93 The Board decided not to require retrospective application of the amendments in accordance with IAS 8. Instead, it decided to require entities to 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. It concluded that these requirements appropriately balance expected benefits and costs. Retrospective application would require entities to retrospectively assess whether each lease and decommissioning obligation gave rise to equal taxable and deductible temporary differences on initial recognition, which could have occurred a long time ago. The Board concluded that its transition approach would, therefore, make the amendments easier and less costly to apply than a full retrospective approach, while still achieving their objective. Such an approach also prevents any uncertainty about how the amendments interact with the transition requirements in IFRS 16.

BC94 The Board also required entities to apply the amendments prospectively to transactions other than leases and decommissioning obligations (that is, to such transactions that occur on or after the beginning of the earliest comparative period presented). Were the amendments to be applied retrospectively, determining whether such transactions are in the scope of the amendments and then reconsidering the accounting for those transactions could be costly and complex. The Board concluded that the costs of requiring

entities to apply the amendments retrospectively for those other transactions would outweigh the benefits of doing so.

- BC95 For reasons similar to those explained in paragraph BC93, the Board required first-time adopters to recognise deferred tax for all temporary differences associated with leases and decommissioning obligations existing at the date of transition to IFRSs.

## **International Tax Reform—Pillar Two Model Rules (2023 amendments)**

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- BC96 In May 2023, the IASB issued *International Tax Reform—Pillar Two Model Rules*. The amendments introduced:
- (a) a temporary exception to the requirements to recognise and disclose information about deferred tax assets and liabilities related to Pillar Two income taxes; and
  - (b) targeted disclosure requirements for affected entities.

### **Background**

#### **Pillar Two model rules**

- BC97 In October 2021, more than 135 jurisdictions agreed to the Organisation for Economic Co-operation and Development (OECD)/G20 Inclusive Framework on Base Erosion and Profit Shifting's *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*. Since then, the OECD has published model rules and other documents related to the second pillar of this solution (the Pillar Two model rules).
- BC98 The Pillar Two model rules provide a template that jurisdictions can translate into domestic tax law and implement as part of an agreed common approach. The rules:
- (a) aim to ensure that large multinational groups pay a minimum amount of tax on income arising in each jurisdiction in which they operate;
  - (b) would achieve that aim by applying a system of top-up taxes that results in the total amount of taxes payable on excess profit in each jurisdiction representing at least the minimum rate of 15%; and
  - (c) typically require the ultimate parent entity of a group to pay top-up tax—in the jurisdiction in which it is domiciled—on profits of its subsidiaries that are taxed below 15%.

#### **Potential implications for income tax accounting**

- BC99 Stakeholders informed the IASB of concerns about the implications for income tax accounting resulting from jurisdictions implementing the Pillar Two model rules within a short period of time. Those concerns related to:

- (a) *the scope of IAS 12* – stakeholders were generally of the view that top-up tax is an income tax – and therefore within the scope of IAS 12 – in the consolidated financial statements of the ultimate parent entity of a group subject to the rules. However, stakeholders said it was unclear whether top-up tax is an income tax in the financial statements of a group’s subsidiaries – for example, if an entity is liable to pay such tax with respect to profits of entities that are not part of its reporting group (such as with respect to a fellow subsidiary’s profits).
- (b) *the accounting for deferred taxes* – stakeholders said it was unclear how an entity would account for deferred taxes related to top-up tax. For example, they asked:
  - (i) do the rules create additional temporary differences? In particular, is it possible to link directly the recovery or settlement of the carrying amount of assets and liabilities to future top-up tax payments (or to the reduction of these payments)?
  - (ii) should an entity remeasure deferred taxes recognised under domestic tax regimes to reflect potential top-up tax payable under the Pillar Two model rules?
  - (iii) which tax rate should an entity use to measure deferred taxes related to top-up tax, considering that paragraph 47 of IAS 12 requires an entity to use the tax rates expected to apply in future periods? The tax rates that will apply in these periods depend on several factors that are difficult – if not impossible – to forecast reliably.
- (c) *the usefulness of deferred tax information* – stakeholders questioned the usefulness of the information that would result from recognising deferred taxes related to top-up tax, particularly if an entity is required to estimate the tax rate to apply in measuring these deferred taxes.
- (d) *the urgent need for clarity* – stakeholders said there was little time to resolve the uncertainties about how to apply IAS 12 in accounting for top-up tax given the imminent implementation of the rules in some jurisdictions. This lack of clarity would result in diversity in the accounting applied by affected entities and information that is potentially not useful.

### **Temporary exception to deferred tax accounting**

BC100 After considering stakeholders’ concerns, the IASB agreed that entities need time to determine how to apply the principles and requirements in IAS 12 to account for deferred taxes related to top-up tax. The IASB also needs time to engage further with stakeholders and to consider whether any action is needed to support the consistent application of IAS 12. The IASB concluded that it was not feasible to complete these activities before jurisdictions enact new tax laws and thus before entities are required to reflect those laws in accounting for deferred taxes.

- BC101 The IASB therefore decided to introduce a temporary exception to the requirements in IAS 12 to recognise and disclose information about deferred tax assets and liabilities related to Pillar Two income taxes. The IASB concluded that doing so would:
- (a) provide affected entities with relief from accounting for deferred tax assets and liabilities in relation to complex new tax legislation to be enacted by multiple jurisdictions in a short period of time;
  - (b) avoid the development of diverse interpretations of IAS 12 and the resulting inconsistent application of the Standard; and
  - (c) allow time for stakeholders to assess how the Pillar Two model rules have been implemented in different jurisdictions, for entities to assess how they are affected and for the IASB to consider whether to do further work.
- BC102 The IASB also decided to require an entity to disclose that it has applied the temporary exception. The IASB concluded that this requirement would:
- (a) provide entity-specific information because some entities are unaffected by Pillar Two legislation and, therefore, would not apply the exception; and
  - (b) make the exception's application transparent to users of financial statements during the periods in which it is applied.

### **Scope**

- BC103 The IASB decided not to provide further clarifications or guidance on the circumstances in which top-up tax is an income tax (see paragraph BC99(a)). The IASB concluded that it would not be possible to do so without delaying the finalisation of amendments that were urgently needed. The IASB also decided not to require entities to deem top-up tax to be an income tax in all circumstances because that could have resulted in unintended consequences. Therefore, an entity determines whether, in its circumstances, top-up tax is an income tax before applying the requirements in IAS 12.
- BC104 The IASB decided it was unnecessary to expand the scope of the temporary exception to include the measurement of deferred taxes recognised under domestic tax regimes. The IASB concluded that an entity would not remeasure such deferred taxes to reflect Pillar Two income taxes it expects to pay when recovering or settling a related asset or liability because the temporary exception applies to deferred tax assets and liabilities related to such income taxes.

### **Mandatory application**

- BC105 The IASB decided to make the application of the temporary exception mandatory because doing so would:
- (a) result in greater comparability between entities' financial statements and, therefore, more useful information for users of financial statements; and

- (b) eliminate the risk of entities inadvertently developing accounting policies that are inconsistent with the principles and requirements in IAS 12.

### **Duration**

- BC106 The IASB concluded that it was not possible to determine how much time would be required for the activities described in paragraph BC100 because they would depend on how and when jurisdictions implement the Pillar Two model rules. Therefore, the IASB decided not to specify how long the temporary exception will be in place. The IASB also decided to monitor developments related to the implementation of the Pillar Two model rules to determine when to do further work.

### **Disclosures**

#### **Periods before legislation is in effect**

##### *Disclosure objective*

- BC107 In periods in which Pillar Two legislation is enacted or substantively enacted but not yet in effect, users of financial statements need information that helps them understand an entity's exposure to Pillar Two income taxes arising from that legislation. In these periods, the enacted legislation could create exposures that are not yet reflected in the entity's income tax expense for the period, and users might be unable to understand such exposures from other information an entity discloses in its financial statements. Accordingly, the IASB decided to set a disclosure objective based on this information need.

##### *Information that meets the disclosure objective*

- BC108 The IASB considered that an entity was likely to be in the process of assessing its exposure and preparing to comply with Pillar Two legislation in periods in which the legislation is enacted or substantively enacted but not yet in effect. Requiring an entity to disclose information reflecting all the specific requirements of the legislation would either not be feasible or be likely to result in undue cost or effort. Consequently, when it exposed draft amendments for comment, the IASB proposed requiring an entity to disclose specific items of information based on the requirements in IAS 12. However, feedback suggested the benefits of disclosing such information might not outweigh the costs of preparing it, particularly because:
- (a) information based on the requirements in IAS 12 differs from that based on the requirements of the Pillar Two model rules. Respondents expressed mixed views about the usefulness of information based on the requirements in IAS 12 for the purpose of informing users of financial statements about an entity's exposure to Pillar Two income taxes. Some respondents said the information could be misleading, and that entities might be able and prefer to disclose information available from assessments about their exposure.

- (b) the disclosure requirements are expected to apply to only a few reporting periods. Respondents said the benefits of providing information based on IAS 12 requirements for only a few reporting periods might not outweigh the costs an entity would incur to prepare that information (for example, the costs of setting up new processes).
- BC109 In considering this feedback, the IASB observed that legislation in some jurisdictions was expected to be effective as early as 1 January 2024. Therefore, the IASB expected many entities to have some information about their exposure available to them by the time the disclosure requirements are applicable. For example, some entities might have already made significant progress in assessing their exposure and might be preparing to account for Pillar Two income taxes in their current tax accounting.
- BC110 To balance the factors discussed in paragraphs BC108–BC109, the IASB decided:
- (a) to require an entity to disclose information that meets the disclosure objective, but not to specify the items of information an entity is required to disclose or the basis on which the entity prepares that information. This approach would allow an entity to disclose information that is available from its assessments and that reflects its circumstances, which will vary from entity to entity.
- (b) to require an entity to disclose known or reasonably estimable information. The IASB concluded that this approach is similar to the requirements in paragraphs 30–31 of IAS 8, which apply in a comparable situation. To the extent information is not known or reasonably estimable, the IASB decided to require an entity to disclose instead a statement to that effect and to disclose information about the entity’s progress in assessing its exposure. The IASB concluded that this information would help users of financial statements understand why the entity is unable to disclose further information.
- BC111 Some IASB members were concerned that requiring an entity to disclose only known or reasonably estimable information could result in some entities disclosing no quantitative information to meet the disclosure objective. Nonetheless, having considered the feedback, some IASB members expected that, by the time the disclosure requirements are applicable, many entities are likely to have available to them some known or reasonably estimable information. After considering those views, a majority of IASB members concluded that such a requirement appropriately balances meeting users’ information needs with the cost of reporting such information.
- BC112 The IASB also decided to require that, to meet the disclosure objective, an entity shall disclose:
- (a) information that is both qualitative and quantitative in nature. The IASB considered feedback from users of financial statements that indicated that they need both qualitative and quantitative information to understand an entity’s exposure to Pillar Two income taxes. The IASB included examples of qualitative and quantitative information to

## IAS 12 BC

help an entity understand the type of information it can provide to meet the disclosure objective.

- (b) information based on an entity's circumstances at the end of the reporting period. The IASB concluded that an entity would not have to disclose information about possible future transactions and other possible future events (forward-looking information) to meet this requirement. For example, an entity would not be required to forecast future profits, reflect mitigation actions it expects to take in future periods, or consider possible future changes in tax legislation.

BC113 Furthermore, the IASB clarified that the information an entity is required to disclose to meet the disclosure objective does not have to reflect all the specific requirements of the Pillar Two legislation and can be provided in the form of an indicative range. The IASB concluded that the information an entity discloses to meet the disclosure objective would be useful even if:

- (a) it is prepared on a simplified basis that does not reflect all the specific requirements of the legislation; and
- (b) it lacks a high level of precision.

### **Periods when legislation is in effect**

BC114 The IASB decided to require an entity to disclose separately the current tax expense related to Pillar Two income taxes. The IASB concluded that this information:

- (a) would help users of financial statements understand the magnitude of Pillar Two income taxes relative to an entity's overall tax expense; and
- (b) would not be costly to prepare because an entity would already be required to recognise current tax related to Pillar Two income taxes.

### **Effects analysis**

BC115 The IASB concluded that the benefits of the amendments outweigh the costs because the amendments:

- (a) provide timely relief for affected entities and avoid diverse interpretations of IAS 12 developing in practice;
- (b) safeguard the usefulness of information prepared applying IAS 12 requirements until questions about how to apply the Standard have been resolved; and
- (c) improve the information provided to users of financial statements before and after Pillar Two legislation is in effect.

### **Transition**

BC116 The IASB concluded that:

- (a) for the temporary exception to be effective, it needs to be available to entities immediately upon the issue of the amendments; and
- (b) requiring an entity to apply the disclosure requirements in paragraphs 88B–88D for annual reporting periods beginning on or after 1 January 2023—but not for interim periods ending on or before 31 December 2023—provides an entity with enough time to prepare the required information.

BC117 The IASB decided to require an entity to apply the temporary exception retrospectively. This requirement would result in an entity applying the exception from the date Pillar Two legislation is enacted or substantively enacted—even if that date is before the date of issuing the amendments—and would not result in additional costs.

## Dissenting opinion

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### **Dissent of Zach Gast from *International Tax Reform—Pillar Two Model Rules***

- DO1 Mr Gast voted against issuing *International Tax Reform—Pillar Two Model Rules*. He is concerned that these amendments will result in an entity disclosing less useful information to help users of financial statements assess the entity's future cash flows. The implementation of the Pillar Two model rules will produce a permanent change in how multinational groups are taxed globally. In Mr Gast's view, the disclosure requirements in IAS 12, including those introduced by the amendments, provide insufficient information for users to analyse this change.
- DO2 Mr Gast agrees the IASB should introduce the temporary exception for cost-benefit reasons. However, he is of the view that the exception results in a significant loss of information for users of financial statements and that effective disclosures are necessary to compensate for that loss. Mr Gast agrees that the amendments should allow for effective objective-based disclosures when information is readily available. However, Mr Gast is of the view that the requirement to disclose known or reasonably estimable information to meet the disclosure objective is not sufficiently stringent without requiring entities to provide alternative quantitative information (a backstop) when information is deemed not known or reasonably estimable. As a result, Mr Gast is concerned that, in periods in which legislation is enacted or substantively enacted but not yet in effect, many entities will provide limited, boilerplate disclosures that do not meet users' information needs.
- DO3 Mr Gast is of the view that introducing a backstop—such as requiring an entity to disclose the specific items of information based on the requirements in IAS 12 that the IASB had proposed when it exposed draft amendments for comment—would have ensured that users of financial statements receive at least a basic set of quantitative information they could use to begin their analyses when an entity concludes there is no known or reasonably estimable information that meets the disclosure objective. Although Mr Gast acknowledges that information based on the requirements in IAS 12 is not fully aligned with the requirements of the Pillar Two model rules, he is of the view that providing no effective disclosures would be misleading and fail to meet the objective of financial statements set out in the *Conceptual Framework for Financial Reporting*.

**IASB documents published to accompany**

**IAS 12**

# Income Taxes

The text of the unaccompanied standard, IAS 12, is contained in Part A of this edition. Its effective date when issued was 1 January 1998. The text of the Basis for Conclusions on IAS 12 is contained in Part C of this edition. This part presents the following documents:

**ILLUSTRATIVE EXAMPLES**

**Examples of temporary differences**

**Illustrative computations and presentation**

## Illustrative Examples

*These illustrative examples accompany, but are not part of, IAS 12.*

### Examples of temporary differences

#### A. Examples of circumstances that give rise to taxable temporary differences

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*All taxable temporary differences give rise to a deferred tax liability.*

##### Transactions that affect profit or loss

- 1 Interest revenue is received in arrears and is included in accounting profit on a time apportionment basis but is included in taxable profit on a cash basis.
- 2 Revenue from the sale of goods is included in accounting profit when goods are delivered but is included in taxable profit when cash is collected. (*note: as explained in B3 below, there is also a deductible temporary difference associated with any related inventory*).
- 3 Depreciation of an asset is accelerated for tax purposes.
- 4 Development costs have been capitalised and will be amortised to the statement of comprehensive income but were deducted in determining taxable profit in the period in which they were incurred.
- 5 Prepaid expenses have already been deducted on a cash basis in determining the taxable profit of the current or previous periods.

##### Transactions that affect the statement of financial position

- 6 Depreciation of an asset is not deductible for tax purposes and no deduction will be available for tax purposes when the asset is sold or scrapped. (*note: paragraph 15(b) of the Standard prohibits recognition of the resulting deferred tax liability unless the asset was acquired in a business combination, see also paragraph 22 of the Standard.*)
- 7 A borrower records a loan at the proceeds received (which equal the amount due at maturity), less transaction costs. Subsequently, the carrying amount of the loan is increased by amortisation of the transaction costs to accounting profit. The transaction costs were deducted for tax purposes in the period when the loan was first recognised. (*notes: (1) the taxable temporary difference is the amount of transaction costs already deducted in determining the taxable profit of current or prior periods, less the cumulative amount amortised to accounting profit; and (2) as the initial recognition of the loan affects taxable profit, the exception in paragraph 15(b) of the Standard does not apply. Therefore, the borrower recognises the deferred tax liability.*)

- 8 A loan payable was measured on initial recognition at the amount of the net proceeds, net of transaction costs. The transaction costs are amortised to accounting profit over the life of the loan. Those transaction costs are not deductible in determining the taxable profit of future, current or prior periods. *(notes: (1) the taxable temporary difference is the amount of unamortised transaction costs; and (2) paragraph 15(b) of the Standard prohibits recognition of the resulting deferred tax liability.)*
- 9 The liability component of a compound financial instrument (for example a convertible bond) is measured at a discount to the amount repayable on maturity (see IAS 32 *Financial Instruments: Presentation*). The discount is not deductible in determining taxable profit (tax loss).

### **Fair value adjustments and revaluations**

- 10 Financial assets or investment property are carried at fair value which exceeds cost but no equivalent adjustment is made for tax purposes.
- 11 An entity revalues property, plant and equipment (under the revaluation model treatment in IAS 16 *Property, Plant and Equipment*) but no equivalent adjustment is made for tax purposes. *(note: paragraph 61A of the Standard requires the related deferred tax to be recognised in other comprehensive income.)*

### **Business combinations and consolidation**

- 12 The carrying amount of an asset is increased to fair value in a business combination and no equivalent adjustment is made for tax purposes. *(Note that on initial recognition, the resulting deferred tax liability increases goodwill or decreases the amount of any bargain purchase gain recognised. See paragraph 66 of the Standard.)*
- 13 Reductions in the carrying amount of goodwill are not deductible in determining taxable profit and the cost of the goodwill would not be deductible on disposal of the business. *(Note that paragraph 15(a) of the Standard prohibits recognition of the resulting deferred tax liability.)*
- 14 Unrealised losses resulting from intragroup transactions are eliminated by inclusion in the carrying amount of inventory or property, plant and equipment.
- 15 Retained earnings of subsidiaries, branches, associates and joint ventures are included in consolidated retained earnings, but income taxes will be payable if the profits are distributed to the reporting parent. *(note: paragraph 39 of the Standard prohibits recognition of the resulting deferred tax liability if the parent, investor or venturer is able to control the timing of the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.)*
- 16 Investments in foreign subsidiaries, branches or associates or interests in foreign joint ventures are affected by changes in foreign exchange rates. *(notes: (1) there may be either a taxable temporary difference or a deductible temporary difference; and (2) paragraph 39 of the Standard prohibits recognition of the resulting deferred tax liability if the parent, investor or venturer is able to control the timing of the*

*reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.)*

- 17 The non-monetary assets and liabilities of an entity are measured in its functional currency but the taxable profit or tax loss is determined in a different currency. *(notes: (1) there may be either a taxable temporary difference or a deductible temporary difference; (2) where there is a taxable temporary difference, the resulting deferred tax liability is recognised (paragraph 41 of the Standard); and (3) the deferred tax is recognised in profit or loss, see paragraph 58 of the Standard.)*

### Hyperinflation

- 18 Non-monetary assets are restated in terms of the measuring unit current at the end of the reporting period (see IAS 29 *Financial Reporting in Hyperinflationary Economies*) and no equivalent adjustment is made for tax purposes. *(notes: (1) the deferred tax is recognised in profit or loss; and (2) if, in addition to the restatement, the non-monetary assets are also revalued, the deferred tax relating to the revaluation is recognised in other comprehensive income and the deferred tax relating to the restatement is recognised in profit or loss.)*

## B. Examples of circumstances that give rise to deductible temporary differences

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*All deductible temporary differences give rise to a deferred tax asset. However, some deferred tax assets may not satisfy the recognition criteria in paragraph 24 of the Standard.*

### Transactions that affect profit or loss

- 1 Retirement benefit costs are deducted in determining accounting profit as service is provided by the employee, but are not deducted in determining taxable profit until the entity pays either retirement benefits or contributions to a fund. *(note: similar deductible temporary differences arise where other expenses, such as product warranty costs or interest, are deductible on a cash basis in determining taxable profit.)*
- 2 Accumulated depreciation of an asset in the financial statements is greater than the cumulative depreciation allowed up to the end of the reporting period for tax purposes.
- 3 The cost of inventories sold before the end of the reporting period is deducted in determining accounting profit when goods or services are delivered but is deducted in determining taxable profit when cash is collected. *(note: as explained in A2 above, there is also a **taxable** temporary difference associated with the related trade receivable.)*
- 4 The net realisable value of an item of inventory, or the recoverable amount of an item of property, plant or equipment, is less than the previous carrying amount and an entity therefore reduces the carrying amount of the asset, but that reduction is ignored for tax purposes until the asset is sold.

- 5 Research costs (or organisation or other start-up costs) are recognised as an expense in determining accounting profit but are not permitted as a deduction in determining taxable profit until a later period.
- 6 Income is deferred in the statement of financial position but has already been included in taxable profit in current or prior periods.
- 7 A government grant which is included in the statement of financial position as deferred income will not be taxable in future periods. *(note: paragraph 24 of the Standard prohibits the recognition of the resulting deferred tax asset, see also paragraph 33 of the Standard.)*

### **Fair value adjustments and revaluations**

- 8 Financial assets or investment property are carried at fair value which is less than cost, but no equivalent adjustment is made for tax purposes.

### **Business combinations and consolidation**

- 9 A liability is recognised at its fair value in a business combination, but none of the related expense is deducted in determining taxable profit until a later period. *(Note that the resulting deferred tax asset decreases goodwill or increases the amount of any bargain purchase gain recognised. See paragraph 66 of the Standard.)*
- 10 [Deleted]
- 11 Unrealised profits resulting from intragroup transactions are eliminated from the carrying amount of assets, such as inventory or property, plant or equipment, but no equivalent adjustment is made for tax purposes.
- 12 Investments in foreign subsidiaries, branches or associates or interests in foreign joint ventures are affected by changes in foreign exchange rates. *(notes: (1) there may be a taxable temporary difference or a deductible temporary difference; and (2) paragraph 44 of the Standard requires recognition of the resulting deferred tax asset to the extent, and only to the extent, that it is probable that: (a) the temporary difference will reverse in the foreseeable future; and (b) taxable profit will be available against which the temporary difference can be utilised).*
- 13 The non-monetary assets and liabilities of an entity are measured in its functional currency but the taxable profit or tax loss is determined in a different currency. *(notes: (1) there may be either a taxable temporary difference or a deductible temporary difference; (2) where there is a deductible temporary difference, the resulting deferred tax asset is recognised to the extent that it is probable that sufficient taxable profit will be available (paragraph 41 of the Standard); and (3) the deferred tax is recognised in profit or loss, see paragraph 58 of the Standard.)*

**C. Examples of circumstances where the carrying amount of an asset or liability is equal to its tax base**

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- 1 Accrued expenses have already been deducted in determining an entity's current tax liability for the current or earlier periods.
- 2 A loan payable is measured at the amount originally received and this amount is the same as the amount repayable on final maturity of the loan.
- 3 Accrued expenses will never be deductible for tax purposes.
- 4 Accrued income will never be taxable.

## Illustrative computations and presentation

Extracts from statements of financial position and statements of comprehensive income are provided to show the effects on these financial statements of the transactions described below. These extracts do not necessarily conform with all the disclosure and presentation requirements of other Standards.

All the examples below assume that the entities concerned have no transaction other than those described.

### Example 1 – Depreciable assets

An entity buys equipment for 10,000 and depreciates it on a straight-line basis over its expected useful life of five years. For tax purposes, the equipment is depreciated at 25% a year on a straight-line basis. Tax losses may be carried back against taxable profit of the previous five years. In year 0, the entity's taxable profit was 5,000. The tax rate is 40%.

The entity will recover the carrying amount of the equipment by using it to manufacture goods for resale. Therefore, the entity's current tax computation is as follows:

	Year				
	1	2	3	4	5
Taxable income	2,000	2,000	2,000	2,000	2,000
Depreciation for tax purposes	2,500	2,500	2,500	2,500	0
Taxable profit (tax loss)	<u>(500)</u>	<u>(500)</u>	<u>(500)</u>	<u>(500)</u>	<u>2,000</u>
Current tax expense (income) at 40%	<u>(200)</u>	<u>(200)</u>	<u>(200)</u>	<u>(200)</u>	<u>800</u>

The entity recognises a current tax asset at the end of years 1 to 4 because it recovers the benefit of the tax loss against the taxable profit of year 0.

The temporary differences associated with the equipment and the resulting deferred tax asset and liability and deferred tax expense and income are as follows:

	Year				
	1	2	3	4	5
Carrying amount	8,000	6,000	4,000	2,000	0
Tax base	7,500	5,000	2,500	0	0
Taxable temporary difference	<u>500</u>	<u>1,000</u>	<u>1,500</u>	<u>2,000</u>	<u>0</u>
Opening deferred tax liability	0	200	400	600	800
Deferred tax expense (income)	<u>200</u>	<u>200</u>	<u>200</u>	<u>200</u>	<u>(800)</u>
Closing deferred tax liability	<u>200</u>	<u>400</u>	<u>600</u>	<u>800</u>	<u>0</u>

The entity recognises the deferred tax liability in years 1 to 4 because the reversal of the taxable temporary difference will create taxable income in subsequent years. The entity's statement of comprehensive income includes the following:

	Year				
	1	2	3	4	5
Income	2,000	2,000	2,000	2,000	2,000
Depreciation	2,000	2,000	2,000	2,000	2,000
Profit before tax	0	0	0	0	0
Current tax expense (income)	(200)	(200)	(200)	(200)	800
Deferred tax expense (income)	200	200	200	200	(800)
Total tax expense (income)	0	0	0	0	0
Profit for the period	0	0	0	0	0

### Example 2 – Deferred tax assets and liabilities

The example deals with an entity over the two-year period, X5 and X6. In X5 the enacted income tax rate was 40% of taxable profit. In X6 the enacted income tax rate was 35% of taxable profit.

Charitable donations are recognised as an expense when they are paid and are not deductible for tax purposes.

In X5, the entity was notified by the relevant authorities that they intend to pursue an action against the entity with respect to sulphur emissions. Although as at December X6 the action had not yet come to court the entity recognised a liability of 700 in X5 being its best estimate of the fine arising from the action. Fines are not deductible for tax purposes.

In X2, the entity incurred 1,250 of costs in relation to the development of a new product. These costs were deducted for tax purposes in X2. For accounting purposes, the entity capitalised this expenditure and amortised it on the straight-line basis over five years. At 31/12/X4, the unamortised balance of these product development costs was 500.

In X5, the entity entered into an agreement with its existing employees to provide healthcare benefits to retirees. The entity recognises as an expense the cost of this plan as employees provide service. No payments to retirees were made for such benefits in X5 or X6. Healthcare costs are deductible for tax purposes when payments are made to retirees. The entity has determined that it is probable that taxable profit will be available against which any resulting deferred tax asset can be utilised.

Buildings are depreciated for accounting purposes at 5% a year on a straight-line basis and at 10% a year on a straight-line basis for tax purposes. Motor vehicles are depreciated for accounting purposes at 20% a year on a straight-line basis and at 25% a year on a straight-line basis for tax purposes. A full year's depreciation is charged for accounting purposes in the year that an asset is acquired.

At 1/1/X6, the building was revalued to 65,000 and the entity estimated that the remaining useful life of the building was 20 years from the date of the revaluation. The revaluation did not affect taxable profit in X6 and the taxation authorities did not adjust the tax base of the building to reflect the revaluation. In X6, the entity transferred 1,033 from revaluation surplus to retained earnings. This represents the difference of 1,590 between the actual depreciation on the building (3,250) and equivalent depreciation

based on the cost of the building (1,660, which is the book value at 1/1/X6 of 33,200 divided by the remaining useful life of 20 years), less the related deferred tax of 557 (see paragraph 64 of the Standard).

**Current tax expense**

	<b>X5</b>	<b>X6</b>
Accounting profit	8,775	8,740
<i>Add</i>		
Depreciation for accounting purposes	4,800	8,250
Charitable donations	500	350
Fine for environmental pollution	700	–
Product development costs	250	250
Healthcare benefits	2,000	1,000
	<u>17,025</u>	<u>18,590</u>
<i>Deduct</i>		
Depreciation for tax purposes	<u>(8,100)</u>	<u>(11,850)</u>
Taxable profit	<u>8,925</u>	<u>6,740</u>
Current tax expense at 40%	<u>3,570</u>	
Current tax expense at 35%		<u>2,359</u>

**Carrying amounts of property, plant and equipment**

	<b>Building</b>	<b>Motor vehicles</b>	<b>Total</b>
Balance at 31/12/X4	50,000	10,000	60,000
Additions X5	6,000	–	6,000
Balance at 31/12/X5	<u>56,000</u>	<u>10,000</u>	<u>66,000</u>
Elimination of accumulated depreciation on revaluation at 1/1/X6	(22,800)	–	(22,800)
Revaluation at 1/1/X6	<u>31,800</u>	<u>–</u>	<u>31,800</u>
Balance at 1/1/X6	65,000	10,000	75,000
Additions X6	–	15,000	15,000
	<u>65,000</u>	<u>25,000</u>	<u>90,000</u>
<i>Accumulated depreciation</i>	5%	20%	
Balance at 31/12/X4	20,000	4,000	24,000
Depreciation X5	2,800	2,000	4,800
Balance at 31/12/X5	<u>22,800</u>	<u>6,000</u>	<u>28,800</u>
Revaluation at 1/1/X6	(22,800)	–	(22,800)
Balance at 1/1/X6	–	6,000	6,000
Depreciation X6	3,250	5,000	8,250
Balance at 31/12/X6	<u>3,250</u>	<u>11,000</u>	<u>14,250</u>
<i>Carrying amount</i>			
31/12/X4	<u>30,000</u>	<u>6,000</u>	<u>36,000</u>
31/12/X5	<u>33,200</u>	<u>4,000</u>	<u>37,200</u>
31/12/X6	<u>61,750</u>	<u>14,000</u>	<u>75,750</u>

**Tax base of property, plant and equipment**

	<b>Building</b>	<b>Motor vehicles</b>	<b>Total</b>
<i>Cost</i>			
Balance at 31/12/X4	50,000	10,000	60,000
Additions X5	6,000	–	6,000
Balance at 31/12/X5	<u>56,000</u>	<u>10,000</u>	<u>66,000</u>
Additions X6	–	15,000	15,000
Balance at 31/12/X6	<u><u>56,000</u></u>	<u><u>25,000</u></u>	<u><u>81,000</u></u>
<i>Accumulated depreciation</i>			
	10%	25%	
Balance at 31/12/X4	40,000	5,000	45,000
Depreciation X5	5,600	2,500	8,100
Balance at 31/12/X5	<u>45,600</u>	<u>7,500</u>	<u>53,100</u>
Depreciation X6	5,600	6,250	11,850
Balance 31/12/X6	<u><u>51,200</u></u>	<u><u>13,750</u></u>	<u><u>64,950</u></u>
<i>Tax base</i>			
31/12/X4	<u>10,000</u>	<u>5,000</u>	<u>15,000</u>
31/12/X5	<u>10,400</u>	<u>2,500</u>	<u>12,900</u>
31/12/X6	<u><u>4,800</u></u>	<u><u>11,250</u></u>	<u><u>16,050</u></u>

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**Deferred tax assets, liabilities and expense at 31/12/X4**

	<b>Carrying amount</b>	<b>Tax base</b>	<b>Temporary differences</b>
Accounts receivable	500	500	–
Inventory	2,000	2,000	–
Product development costs	500	–	500
Investments	33,000	33,000	–
Property, plant & equipment	36,000	15,000	21,000
<b>TOTAL ASSETS</b>	<u>72,000</u>	<u>50,500</u>	<u>21,500</u>
Current income taxes payable	3,000	3,000	–
Accounts payable	500	500	–
Fines payable	–	–	–
Liability for healthcare benefits	–	–	–
Long-term debt	20,000	20,000	–
Deferred income taxes	8,600	8,600	–
<b>TOTAL LIABILITIES</b>	<u>32,100</u>	<u>32,100</u>	
Share capital	5,000	5,000	–
Revaluation surplus	–	–	–
Retained earnings	34,900	13,400	
<b>TOTAL LIABILITIES/EQUITY</b>	<u>72,000</u>	<u>50,500</u>	
<b>TEMPORARY DIFFERENCES</b>			<u>21,500</u>
Deferred tax liability	21,500 at 40%		8,600
Deferred tax asset	–	–	–
<b>Net deferred tax liability</b>			<u>8,600</u>

**Deferred tax assets, liabilities and expense at 31/12/X5**

	<b>Carrying amount</b>	<b>Tax base</b>	<b>Temporary differences</b>
Accounts receivable	500	500	–
Inventory	2,000	2,000	–
Product development costs	250	–	250
Investments	33,000	33,000	–
Property, plant & equipment	37,200	12,900	24,300
<b>TOTAL ASSETS</b>	<u>72,950</u>	<u>48,400</u>	<u>24,550</u>
Current income taxes payable	3,570	3,570	–
Accounts payable	500	500	–
Fines payable	700	700	–
Liability for healthcare benefits	2,000	–	(2,000)
Long-term debt	12,475	12,475	–
Deferred income taxes	9,020	9,020	
<b>TOTAL LIABILITIES</b>	<u>28,265</u>	<u>26,265</u>	<u>(2,000)</u>
Share capital	5,000	5,000	–
Revaluation surplus	–	–	–
Retained earnings	39,685	17,135	
<b>TOTAL LIABILITIES/EQUITY</b>	<u>72,950</u>	<u>48,400</u>	
<b>TEMPORARY DIFFERENCES</b>			<u>22,550</u>
Deferred tax liability	24,550 at 40%		9,820
Deferred tax asset	2,000 at 40%		(800)
Net deferred tax liability			9,020
Less: Opening deferred tax liability			(8,600)
Deferred tax expense (income) related to the origination and reversal of temporary differences			<u>420</u>

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**Deferred tax assets, liabilities and expense at 31/12/X6**

	Carrying amount	Tax base	Temporary differences
Accounts receivable	500	500	–
Inventory	2,000	2,000	–
Product development costs	–	–	–
Investments	33,000	33,000	–
Property, plant & equipment	75,750	16,050	59,700
<b>TOTAL ASSETS</b>	<u>111,250</u>	<u>51,550</u>	<u>59,700</u>
Current income taxes payable	2,359	2,359	–
Accounts payable	500	500	–
Fines payable	700	700	–
Liability for healthcare benefits	3,000	–	(3,000)
Long-term debt	12,805	12,805	–
Deferred income taxes	19,845	19,845	–
<b>TOTAL LIABILITIES</b>	<u>39,209</u>	<u>36,209</u>	<u>(3,000)</u>
Share capital	5,000	5,000	–
Revaluation surplus	19,637	–	–
Retained earnings	47,404	10,341	–
<b>TOTAL LIABILITIES/EQUITY</b>	<u>111,250</u>	<u>51,550</u>	<u>–</u>
<b>TEMPORARY DIFFERENCES</b>			<u>56,700</u>
Deferred tax liability	59,700 at 35%		20,895
Deferred tax asset	3,000 at 35%		(1,050)
Net deferred tax liability			19,845
Less: Opening deferred tax liability			(9,020)
Adjustment to opening deferred tax liability resulting from reduction in tax rate	22,550 at 5%		1,127
Deferred tax attributable to revaluation surplus	31,800 at 35%		(11,130)
Deferred tax expense (income) related to the origination and reversal of temporary differences			<u>822</u>

## Illustrative disclosure

The amounts to be disclosed in accordance with the Standard are as follows:

### Major components of tax expense (income) (paragraph 79)

	X5	X6
Current tax expense	3,570	2,359
Deferred tax expense relating to the origination and reversal of temporary differences:	420	822
Deferred tax expense (income) resulting from reduction in tax rate	–	(1,127)
Tax expense	<u>3,990</u>	<u>2,054</u>

### Income tax relating to the components of other comprehensive income (paragraph 81(ab))

Deferred tax relating to revaluation of building	–	<u>(11,130)</u>
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In addition, deferred tax of 557 was transferred in X6 from retained earnings to revaluation surplus. This relates to the difference between the actual depreciation on the building and equivalent depreciation based on the cost of the building.

### Explanation of the relationship between tax expense and accounting profit (paragraph 81(c))

The Standard permits two alternative methods of explaining the relationship between tax expense (income) and accounting profit. Both of these formats are illustrated below.

- (i) a numerical reconciliation between tax expense (income) and the product of accounting profit multiplied by the applicable tax rate(s), disclosing also the basis on which the applicable tax rate(s) is (are) computed

	X5	X6
Accounting profit	<u>8,775</u>	<u>8,740</u>
Tax at the applicable tax rate of 35% (X5: 40%)	3,510	3,059
Tax effect of expenses that are not deductible in determining taxable profit:		
Charitable donations	200	122
Fines for environmental pollution	280	–
Reduction in opening deferred taxes resulting from reduction in tax rate	–	(1,127)
Tax expense	<u>3,990</u>	<u>2,054</u>

The applicable tax rate is the aggregate of the national income tax rate of 30% (X5: 35%) and the local income tax rate of 5%.

- (ii) a numerical reconciliation between the average effective tax rate and the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed

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	X5 %	X6 %
Applicable tax rate	40.0	35.0
Tax effect of expenses that are not deductible for tax purposes:		
Charitable donations	2.3	1.4
Fines for environmental pollution	3.2	–
Effect on opening deferred taxes of reduction in tax rate	–	(12.9)
Average effective tax rate (tax expense divided by profit before tax)	<u>45.5</u>	<u>23.5</u>

The applicable tax rate is the aggregate of the national income tax rate of 30% (X5: 35%) and the local income tax rate of 5%.

**An explanation of changes in the applicable tax rate(s) compared to the previous accounting period (paragraph 81(d))**

In X6, the government enacted a change in the national income tax rate from 35% to 30%.

**In respect of each type of temporary difference, and in respect of each type of unused tax losses and unused tax credits:**

- (i) the amount of the deferred tax assets and liabilities recognised in the statement of financial position for each period presented;
- (ii) the amount of the deferred tax income or expense recognised in profit or loss for each period presented, if this is not apparent from the changes in the amounts recognised in the statement of financial position (paragraph 81(g)).

	X5	X6
Accelerated depreciation for tax purposes	9,720	10,322
Liabilities for healthcare benefits that are deducted for tax purposes only when paid	(800)	(1,050)
Product development costs deducted from taxable profit in earlier years	100	–
Revaluation, net of related depreciation	–	10,573
Deferred tax liability	<u>9,020</u>	<u>19,845</u>

*(note: the amount of the deferred tax income or expense recognised in profit or loss for the current year is apparent from the changes in the amounts recognised in the statement of financial position)*

### Example 3 – Business combinations

On 1 January X5 entity A acquired 100 per cent of the shares of entity B at a cost of 600. At the acquisition date, the tax base in A's tax jurisdiction of A's investment in B is 600. Reductions in the carrying amount of goodwill are not deductible for tax purposes, and the cost of the goodwill would also not be deductible if B were to dispose of its underlying business. The tax rate in A's tax jurisdiction is 30 per cent and the tax rate in B's tax jurisdiction is 40 per cent.

The fair value of the identifiable assets acquired and liabilities assumed (excluding deferred tax assets and liabilities) by A is set out in the following table, together with their tax bases in B's tax jurisdiction and the resulting temporary differences.

	Amount recognised at acquisition	Tax base	Temporary differences
Property, plant and equipment	270	155	115
Accounts receivable	210	210	–
Inventory	174	124	50
Retirement benefit obligations	(30)	–	(30)
Accounts payable	(120)	(120)	–
Identifiable assets acquired and liabilities assumed, excluding deferred tax	<u>504</u>	<u>369</u>	<u>135</u>

The deferred tax asset arising from the retirement benefit obligations is offset against the deferred tax liabilities arising from the property, plant and equipment and inventory (see paragraph 74 of the Standard).

No deduction is available in B's tax jurisdiction for the cost of the goodwill. Therefore, the tax base of the goodwill in B's jurisdiction is nil. However, in accordance with paragraph 15(a) of the Standard, A recognises no deferred tax liability for the taxable temporary difference associated with the goodwill in B's tax jurisdiction.

The carrying amount, in A's consolidated financial statements, of its investment in B is made up as follows:

Fair value of identifiable assets acquired and liabilities assumed, excluding deferred tax	504
Deferred tax liability (135 at 40%)	(54)
Fair value of identifiable assets acquired and liabilities assumed	<u>450</u>
Goodwill	<u>150</u>
Carrying amount	<u><u>600</u></u>

Because, at the acquisition date, the tax base in A's tax jurisdiction, of A's investment in B is 600, no temporary difference is associated in A's tax jurisdiction with the investment.

During X5, B's equity (incorporating the fair value adjustments made as a result of the business combination) changed as follows:

At 1 January X5	450
Retained profit for X5 (net profit of 150, less dividend payable of 80)	<u>70</u>
At 31 December X5	<u><u>520</u></u>

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A recognises a liability for any withholding tax or other taxes that it will incur on the accrued dividend receivable of 80.

At 31 December X5, the carrying amount of A's underlying investment in B, excluding the accrued dividend receivable, is as follows:

Net assets of B	520
Goodwill	150
Carrying amount	<u>670</u>

The temporary difference associated with A's underlying investment is 70. This amount is equal to the cumulative retained profit since the acquisition date.

If A has determined that it will not sell the investment in the foreseeable future and that B will not distribute its retained profits in the foreseeable future, no deferred tax liability is recognised in relation to A's investment in B (see paragraphs 39 and 40 of the Standard). Note that this exception would apply for an investment in an associate only if there is an agreement requiring that the profits of the associate will not be distributed in the foreseeable future (see paragraph 42 of the Standard). A discloses the amount of the temporary difference for which no deferred tax is recognised, ie 70 (see paragraph 81(f) of the Standard).

If A expects to sell the investment in B, or that B will distribute its retained profits in the foreseeable future, A recognises a deferred tax liability to the extent that the temporary difference is expected to reverse. The tax rate reflects the manner in which A expects to recover the carrying amount of its investment (see paragraph 51 of the Standard). A recognises the deferred tax in other comprehensive income to the extent that the deferred tax results from foreign exchange translation differences that have been recognised in other comprehensive income (paragraph 61A of the Standard). A discloses separately:

- (a) the amount of deferred tax that has been recognised in other comprehensive income (paragraph 81(ab) of the Standard); and
- (b) the amount of any remaining temporary difference which is not expected to reverse in the foreseeable future and for which, therefore, no deferred tax is recognised (see paragraph 81(f) of the Standard).

### Example 4 – Compound financial instruments

An entity receives a non-interest-bearing convertible loan of 1,000 on 31 December X4 repayable at par on 1 January X8. In accordance with IAS 32 *Financial Instruments: Presentation* the entity classifies the instrument's liability component as a liability and the equity component as equity. The entity assigns an initial carrying amount of 751 to the liability component of the convertible loan and 249 to the equity component. Subsequently, the entity recognises imputed discount as interest expense at an annual rate of 10% on the carrying amount of the liability component at the beginning of the year. The tax authorities do not allow the entity to claim any deduction for the imputed discount on the liability component of the convertible loan. The tax rate is 40%.

The temporary differences associated with the liability component and the resulting deferred tax liability and deferred tax expense and income are as follows:

	Year			
	X4	X5	X6	X7
Carrying amount of liability component	751	826	909	1,000
Tax base	1,000	1,000	1,000	1,000
Taxable temporary difference	<u>249</u>	<u>174</u>	<u>91</u>	<u>–</u>
Opening deferred tax liability at 40%	0	100	70	37
Deferred tax charged to equity	100	–	–	–
Deferred tax expense (income)	–	(30)	(33)	(37)
Closing deferred tax liability at 40%	<u>100</u>	<u>70</u>	<u>37</u>	<u>–</u>

As explained in paragraph 23 of the Standard, at 31 December X4, the entity recognises the resulting deferred tax liability by adjusting the initial carrying amount of the equity component of the convertible liability. Therefore, the amounts recognised at that date are as follows:

Liability component	751
Deferred tax liability	100
Equity component (249 less 100)	<u>149</u>
	<u>1,000</u>

Subsequent changes in the deferred tax liability are recognised in profit or loss as tax income (see paragraph 23 of the Standard). Therefore, the entity's profit or loss includes the following:

	Year			
	X4	X5	X6	X7
Interest expense (imputed discount)	–	75	83	91
Deferred tax expense (income)	<u>–</u>	<u>(30)</u>	<u>(33)</u>	<u>(37)</u>
	<u>–</u>	<u>45</u>	<u>50</u>	<u>54</u>

### Example 5 – Share-based payment transactions

In accordance with IFRS 2 *Share-based Payment*, an entity has recognised an expense for the consumption of employee services received as consideration for share options granted. A tax deduction will not arise until the options are exercised, and the deduction is based on the options' intrinsic value at exercise date.

As explained in paragraph 68B of the Standard, the difference between the tax base of the employee services received to date (being the amount the taxation authorities will permit as a deduction in future periods in respect of those services), and the carrying amount of nil, is a deductible temporary difference that results in a deferred tax asset. Paragraph 68B requires that, if the amount the taxation authorities will permit as a

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deduction in future periods is not known at the end of the period, it should be estimated, based on information available at the end of the period. If the amount that the taxation authorities will permit as a deduction in future periods is dependent upon the entity's share price at a future date, the measurement of the deductible temporary difference should be based on the entity's share price at the end of the period. Therefore, in this example, the estimated future tax deduction (and hence the measurement of the deferred tax asset) should be based on the options' intrinsic value at the end of the period.

As explained in paragraph 68C of the Standard, if the tax deduction (or estimated future tax deduction) exceeds the amount of the related cumulative remuneration expense, this indicates that the tax deduction relates not only to remuneration expense but also to an equity item. In this situation, paragraph 68C requires that the excess of the associated current or deferred tax should be recognised directly in equity.

The entity's tax rate is 40 per cent. The options were granted at the start of year 1, vested at the end of year 3 and were exercised at the end of year 5. Details of the expense recognised for employee services received and consumed in each accounting period, the number of options outstanding at each year-end, and the intrinsic value of the options at each year-end, are as follows:

	<b>Employee services expense</b>	<b>Number of options at year-end</b>	<b>Intrinsic value per option</b>
Year 1	188,000	50,000	5
Year 2	185,000	45,000	8
Year 3	190,000	40,000	13
Year 4	0	40,000	17
Year 5	0	40,000	20

The entity recognises a deferred tax asset and deferred tax income in years 1–4 and current tax income in year 5 as follows. In years 4 and 5, some of the deferred and current tax income is recognised directly in equity, because the estimated (and actual) tax deduction exceeds the cumulative remuneration expense.

### Year 1

Deferred tax asset and deferred tax income:

$$(50,000 \times 5 \times \frac{1}{3}^{(a)} \times 0.40) = \underline{\underline{33,333}}$$

- (a) The tax base of the employee services received is based on the intrinsic value of the options, and those options were granted for three years' services. Because only one year's services have been received to date, it is necessary to multiply the option's intrinsic value by one-third to arrive at the tax base of the employee services received in year 1.

The deferred tax income is all recognised in profit or loss, because the estimated future tax deduction of 83,333 ( $50,000 \times 5 \times \frac{1}{3}$ ) is less than the cumulative remuneration expense of 188,000.

**Year 2**

Deferred tax asset at year-end:

$(45,000 \times 8 \times \frac{2}{3} \times 0.40) =$	96,000	
Less deferred tax asset at start of year	(33,333)	
Deferred tax income for year	<u>62,667*</u>	<u>62,667*</u>

\* This amount consists of the following:

Deferred tax income for the temporary difference between the tax base of the employee services received during the year and their carrying amount of nil:

$(45,000 \times 8 \times \frac{1}{3} \times 0.40)$	48,000	
Tax income resulting from an adjustment to the tax base of employee services received in previous years:		
(a) increase in intrinsic value: $(45,000 \times 3 \times \frac{1}{3} \times 0.40)$	18,000	
(b) decrease in number of options: $(5,000 \times 5 \times \frac{1}{3} \times 0.40)$	(3,333)	
Deferred tax income for year	<u>62,667</u>	<u>62,667</u>

The deferred tax income is all recognised in profit or loss, because the estimated future tax deduction of 240,000  $(45,000 \times 8 \times \frac{2}{3})$  is less than the cumulative remuneration expense of 373,000  $(188,000 + 185,000)$ .

**Year 3**

Deferred tax asset at year-end:

$(40,000 \times 13 \times 0.40) =$	208,000	
Less deferred tax asset at start of year	(96,000)	
Deferred tax income for year	<u>112,000</u>	<u>112,000</u>

The deferred tax income is all recognised in profit or loss, because the estimated future tax deduction of 520,000  $(40,000 \times 13)$  is less than the cumulative remuneration expense of 563,000  $(188,000 + 185,000 + 190,000)$ .

**Year 4**

Deferred tax asset at year-end:

$(40,000 \times 17 \times 0.40) =$	272,000	
Less deferred tax asset at start of year	(208,000)	
Deferred tax income for year	<u>64,000</u>	<u>64,000</u>

*continued...*

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...continued

**Year 4**

The deferred tax income is recognised partly in profit or loss and partly directly in equity as follows:

Estimated future tax deduction (40,000 × 17) =	680,000	
Cumulative remuneration expense	563,000	
Excess tax deduction		117,000
Deferred tax income for year	64,000	
Excess recognised directly in equity (117,000 × 0.40) =	46,800	
Recognised in profit or loss		17,200

**Year 5**

Deferred tax expense (reversal of deferred tax asset)	272,000	
Amount recognised directly in equity (reversal of cumulative deferred tax income recognised directly in equity)	46,800	
Amount recognised in profit or loss		225,200
Current tax income based on intrinsic value of options at exercise date (40,000 × 20 × 0.40) =	320,000	
Amount recognised in profit or loss (563,000 × 0.40) =	225,200	
Amount recognised directly in equity		94,800

*Summary*

	Statement of comprehensive income				Statement of financial position	
	Employee services expense	Current tax expense (income)	Deferred tax expense (income)	Total tax expense (income)	Equity	Deferred tax asset
Year 1	188,000	0	(33,333)	(33,333)	0	33,333
Year 2	185,000	0	(62,667)	(62,667)	0	96,000
Year 3	190,000	0	(112,000)	(112,000)	0	208,000
Year 4	0	0	(17,200)	(17,200)	(46,800)	272,000
Year 5	0	(225,200)	225,200	0	46,800	0
					(94,800)	
Totals	563,000	(225,200)	0	(225,200)	(94,800)	0

### Example 6 – Replacement awards in a business combination

On 1 January 20X1 Entity A acquired 100 per cent of Entity B. Entity A pays cash consideration of CU400 to the former owners of Entity B.

At the acquisition date Entity B had outstanding employee share options with a market-based measure of CU100. The share options were fully vested. As part of the business combination Entity B's outstanding share options are replaced by share options of Entity A (replacement awards) with a market-based measure of CU100 and an intrinsic value of CU80. The replacement awards are fully vested. In accordance with paragraphs B56–B62 of IFRS 3 *Business Combinations* (as revised in 2008), the replacement awards are part of the consideration transferred for Entity B. A tax deduction for the replacement awards will not arise until the options are exercised. The tax deduction will be based on the share options' intrinsic value at that date. Entity A's tax rate is 40 per cent. Entity A recognises a deferred tax asset of CU32 (CU80 intrinsic value × 40%) on the replacement awards at the acquisition date.

Entity A measures the identifiable net assets obtained in the business combination (excluding deferred tax assets and liabilities) at CU450. The tax base of the identifiable net assets obtained is CU300. Entity A recognises a deferred tax liability of CU60 ((CU450 – CU300) × 40%) on the identifiable net assets at the acquisition date.

Goodwill is calculated as follows:

	<b>CU</b>
Cash consideration	400
Market-based measure of replacement awards	100
Total consideration transferred	500
Identifiable net assets, excluding deferred tax assets and liabilities	(450)
Deferred tax asset	32
Deferred tax liability	60
<b>Goodwill</b>	<b>78</b>

Reductions in the carrying amount of goodwill are not deductible for tax purposes. In accordance with paragraph 15(a) of the Standard, Entity A recognises no deferred tax liability for the taxable temporary difference associated with the goodwill recognised in the business combination.

The accounting entry for the business combination is as follows:

		<b>CU</b>	<b>CU</b>
Dr	Goodwill	78	
Dr	Identifiable net assets	450	
Dr	Deferred tax asset	32	
	Cr Cash		400
	Cr Equity (replacement awards)		100
	Cr Deferred tax liability		60

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On 31 December 20X1 the intrinsic value of the replacement awards is CU120. Entity A recognises a deferred tax asset of CU48 (CU120 × 40%). Entity A recognises deferred tax income of CU16 (CU48 – CU32) from the increase in the intrinsic value of the replacement awards. The accounting entry is as follows:

		<b>CU</b>	<b>CU</b>
Dr	Deferred tax asset	16	
	Cr Deferred tax income		16

If the replacement awards had not been tax-deductible under current tax law, Entity A would not have recognised a deferred tax asset on the acquisition date. Entity A would have accounted for any subsequent events that result in a tax deduction related to the replacement award in the deferred tax income or expense of the period in which the subsequent event occurred.

Paragraphs B56–B62 of IFRS 3 provide guidance on determining which portion of a replacement award is part of the consideration transferred in a business combination and which portion is attributable to future service and thus a post-combination remuneration expense. Deferred tax assets and liabilities on replacement awards that are post-combination expenses are accounted for in accordance with the general principles as illustrated in Example 5.

### Example 7—Debt instruments measured at fair value

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#### Debt instruments

At 31 December 20X1, Entity Z holds a portfolio of three debt instruments:

Debt Instrument	Cost (CU)	Fair value (CU)	Contractual interest rate
<b>A</b>	2,000,000	1,942,857	2.00%
<b>B</b>	750,000	778,571	9.00%
<b>C</b>	2,000,000	1,961,905	3.00%

Entity Z acquired all the debt instruments on issuance for their nominal value. The terms of the debt instruments require the issuer to pay the nominal value of the debt instruments on their maturity on 31 December 20X2.

Interest is paid at the end of each year at the contractually fixed rate, which equalled the market interest rate when the debt instruments were acquired. At the end of 20X1, the market interest rate is 5 per cent, which has caused the fair value of Debt Instruments A and C to fall below their cost and the fair value of Debt Instrument B to rise above its cost. It is probable that Entity Z will receive all the contractual cash flows if it continues to hold the debt instruments.

At the end of 20X1, Entity Z expects that it will recover the carrying amounts of Debt Instruments A and B through use, ie by continuing to hold them and collecting contractual cash flows, and Debt Instrument C by sale at the beginning of 20X2 for its fair value on 31 December 20X1. It is assumed that no other tax planning opportunity is

available to Entity Z that would enable it to sell Debt Instrument B to generate a capital gain against which it could offset the capital loss arising from selling Debt Instrument C.

The debt instruments are measured at fair value through other comprehensive income in accordance with IFRS 9 *Financial Instruments* (or IAS 39 *Financial Instruments: Recognition and Measurement*<sup>1</sup>).

### **Tax law**

The tax base of the debt instruments is cost, which tax law allows to be offset either on maturity when principal is paid or against the sale proceeds when the debt instruments are sold. Tax law specifies that gains (losses) on the debt instruments are taxable (deductible) only when realised.

Tax law distinguishes ordinary gains and losses from capital gains and losses. Ordinary losses can be offset against both ordinary gains and capital gains. Capital losses can only be offset against capital gains. Capital losses can be carried forward for 5 years and ordinary losses can be carried forward for 20 years.

Ordinary gains are taxed at 30 per cent and capital gains are taxed at 10 per cent.

Tax law classifies interest income from the debt instruments as 'ordinary' and gains and losses arising on the sale of the debt instruments as 'capital'. Losses that arise if the issuer of the debt instrument fails to pay the principal on maturity are classified as ordinary by tax law.

### **General**

On 31 December 20X1, Entity Z has, from other sources, taxable temporary differences of CU50,000 and deductible temporary differences of CU430,000, which will reverse in ordinary taxable profit (or ordinary tax loss) in 20X2.

At the end of 20X1, it is probable that Entity Z will report to the tax authorities an ordinary tax loss of CU200,000 for the year 20X2. This tax loss includes all taxable economic benefits and tax deductions for which temporary differences exist on 31 December 20X1 and that are classified as ordinary by tax law. These amounts contribute equally to the loss for the period according to tax law.

Entity Z has no capital gains against which it can utilise capital losses arising in the years 20X1–20X2.

Except for the information given in the previous paragraphs, there is no further information that is relevant to Entity Z's accounting for deferred taxes in the period 20X1–20X2.

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1 IFRS 9 replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

## Temporary differences

At the end of 20X1, Entity Z identifies the following temporary differences:

	Carrying amount (CU)	Tax base (CU)	Taxable temporary differences (CU)	Deductible temporary differences (CU)
Debt Instrument A	1,942,857	2,000,000		57,143
Debt Instrument B	778,571	750,000	28,571	
Debt Instrument C	1,961,905	2,000,000		38,095
Other sources	Not specified		50,000	430,000

The difference between the carrying amount of an asset or liability and its tax base gives rise to a deductible (taxable) temporary difference (see paragraphs 20 and 26(d) of the Standard). This is because deductible (taxable) temporary differences are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base, which will result in amounts that are deductible (taxable) in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled (see paragraph 5 of the Standard).

## Utilisation of deductible temporary differences

With some exceptions, deferred tax assets arising from deductible temporary differences are recognised to the extent that sufficient future taxable profit will be available against which the deductible temporary differences are utilised (see paragraph 24 of the Standard).

Paragraphs 28–29 of IAS 12 identify the sources of taxable profits against which an entity can utilise deductible temporary differences. They include:

- (a) future reversal of existing taxable temporary differences;
- (b) taxable profit in future periods; and
- (c) tax planning opportunities.

The deductible temporary difference that arises from Debt Instrument C is assessed separately for utilisation. This is because tax law classifies the loss resulting from recovering the carrying amount of Debt Instrument C by sale as capital and allows capital losses to be offset only against capital gains (see paragraph 27A of the Standard).

The separate assessment results in not recognising a deferred tax asset for the deductible temporary difference that arises from Debt Instrument C because Entity Z has no source of taxable profit available that tax law classifies as capital.

In contrast, the deductible temporary difference that arises from Debt Instrument A and other sources are assessed for utilisation in combination with one another. This is because their related tax deductions would be classified as ordinary by tax law.

The tax deductions represented by the deductible temporary differences related to Debt Instrument A are classified as ordinary because the tax law classifies the effect on taxable profit (tax loss) from deducting the tax base on maturity as ordinary.

In assessing the utilisation of deductible temporary differences on 31 December 20X1, the following two steps are performed by Entity Z.

**Step 1: Utilisation of deductible temporary differences because of the reversal of taxable temporary differences (see paragraph 28 of the Standard)**

Entity Z first assesses the availability of taxable temporary differences as follows:

	(CU)
Expected reversal of deductible temporary differences in 20X2	
From Debt Instrument A	57,143
From other sources	430,000
Total reversal of deductible temporary differences	487,143
Expected reversal of taxable temporary differences in 20X2	
From Debt Instrument B	(28,571)
From other sources	(50,000)
Total reversal of taxable temporary differences	(78,571)
Utilisation because of the reversal of taxable temporary differences (Step 1)	78,571
Remaining deductible temporary differences to be assessed for utilisation in Step 2 (487,143 - 78,571)	408,572

In Step 1, Entity Z can recognise a deferred tax asset in relation to a deductible temporary difference of CU78,571.

**Step 2: Utilisation of deductible temporary differences because of future taxable profit (see paragraph 29(a) of the Standard)**

In this step, Entity Z assesses the availability of future taxable profit as follows:

	(CU)
Probable future tax profit (loss) in 20X2 (upon which income taxes are payable (recoverable))	(200,000)
Add back: reversal of deductible temporary differences expected to reverse in 20X2	487,143
Less: reversal of taxable temporary differences (utilised in Step 1)	(78,571)
<b>Probable taxable profit excluding tax deductions for assessing utilisation of deductible temporary differences in 20X2</b>	<b>208,572</b>
Remaining deductible temporary differences to be assessed for utilisation from Step 1	408,572
<b>Utilisation because of future taxable profit (Step 2)</b>	<b>208,572</b>
Utilisation because of the reversal of taxable temporary differences (Step 1)	78,571
<b>Total utilisation of deductible temporary differences</b>	<b>287,143</b>

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The tax loss of CU200,000 includes the taxable economic benefit of CU2 million from the collection of the principal of Debt Instrument A and the equivalent tax deduction, because it is probable that Entity Z will recover the debt instrument for more than its carrying amount (see paragraph 29A of the Standard).

The utilisation of deductible temporary differences is not, however, assessed against probable future taxable profit for a period upon which income taxes are payable (see paragraph 5 of the Standard). Instead, the utilisation of deductible temporary differences is assessed against probable future taxable profit that excludes tax deductions resulting from the reversal of deductible temporary differences (see paragraph 29(a) of the Standard). Assessing the utilisation of deductible temporary differences against probable future taxable profits without excluding those deductions would lead to double counting the deductible temporary differences in that assessment.

In Step 2, Entity Z determines that it can recognise a deferred tax asset in relation to a future taxable profit, excluding tax deductions resulting from the reversal of deductible temporary differences, of CU208,572. Consequently, the total utilisation of deductible temporary differences amounts to CU287,143 (CU78,571 (Step 1) + CU208,572 (Step 2)).

### Measurement of deferred tax assets and deferred tax liabilities

Entity Z presents the following deferred tax assets and deferred tax liabilities in its financial statements on 31 December 20X1:

	(CU)
Total taxable temporary differences	78,571
Total utilisation of deductible temporary differences	287,143
Deferred tax liabilities (78,571 at 30%)	23,571
Deferred tax assets (287,143 at 30%)	86,143

The deferred tax assets and the deferred tax liabilities are measured using the tax rate for ordinary gains of 30 per cent, in accordance with the expected manner of recovery (settlement) of the underlying assets (liabilities) (see paragraph 51 of the Standard).

### Allocation of changes in deferred tax assets between profit or loss and other comprehensive income

Changes in deferred tax that arise from items that are recognised in profit or loss are recognised in profit or loss (see paragraph 58 of the Standard). Changes in deferred tax that arise from items that are recognised in other comprehensive income are recognised in other comprehensive income (see paragraph 61A of the Standard).

Entity Z did not recognise deferred tax assets for all of its deductible temporary differences at 31 December 20X1, and according to tax law all the tax deductions represented by the deductible temporary differences contribute equally to the tax loss for the period. Consequently, the assessment of the utilisation of deductible temporary differences does not specify whether the taxable profits are utilised for deferred tax items that are recognised in profit or loss (ie the deductible temporary differences from other sources) or whether instead the taxable profits are utilised for deferred tax items that are

recognised in other comprehensive income (ie the deductible temporary differences related to debt instruments classified as fair value through other comprehensive income).

For such situations, paragraph 63 of the Standard requires the changes in deferred taxes to be allocated to profit or loss and other comprehensive income on a reasonable pro rata basis or by another method that achieves a more appropriate allocation in the circumstances.

## Example 8—Leases

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### Lease

An entity (Lessee) enters into a five-year lease of a building. The annual lease payments are CU100 payable at the end of each year. Before the commencement date of the lease, Lessee makes a lease payment of CU15 (advance lease payment) and pays initial direct costs of CU5. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate is 5% per year.

At the commencement date, applying IFRS 16 *Leases*, Lessee recognises a lease liability of CU435 (measured at the present value of the five lease payments of CU100, discounted at the interest rate of 5% per year). Lessee measures the right-of-use asset (lease asset) at CU455, comprising the initial measurement of the lease liability (CU435), the advance lease payment (CU15) and the initial direct costs (CU5).

### Tax law

The tax law allows tax deductions for lease payments (including those made before the commencement date) and initial direct costs when an entity makes those payments. Economic benefits that will flow to Lessee when it recovers the carrying amount of the lease asset will be taxable.

A tax rate of 20% is expected to apply to the period(s) when Lessee will recover the carrying amount of the lease asset and will settle the lease liability.

After considering the applicable tax law, Lessee concludes that the tax deductions it will receive for lease payments relate to the repayment of the lease liability.<sup>2</sup>

### Deferred tax on the advance lease payment and initial direct costs

Lessee recognises the advance lease payment (CU15) and initial direct costs (CU5) as components of the lease asset's cost. The tax base of these components is nil because Lessee already received tax deductions for the advance lease payment and initial direct costs when it made those payments. The difference between the tax base (nil) and the carrying amount of each component results in taxable temporary differences of CU15 (related to the advance lease payment) and CU5 (related to the initial direct costs).

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<sup>2</sup> Depending on the applicable tax law, an entity might alternatively conclude that the tax deductions it will receive for lease payments relate to the lease asset, in which case temporary differences would not arise on initial recognition of the lease liability and the related component of the lease asset's cost. Accordingly, the entity would not recognise deferred tax on initial recognition but would do so if and when temporary differences arise after initial recognition.

The exemption from recognising a deferred tax liability in paragraph 15 does not apply because the temporary differences arise from transactions that, at the time of the transactions, affect Lessee's taxable profit (that is, the tax deductions Lessee received when it made the advance lease payment and paid initial direct costs reduced its taxable profit). Accordingly, Lessee recognises a deferred tax liability of CU3 (CU15 × 20%) and CU1 (CU5 × 20%) for the taxable temporary differences related to the advance lease payment and initial direct costs, respectively.

### Deferred tax on the lease liability and related component of the lease asset's cost

At the commencement date, the tax base of the lease liability is nil because Lessee will receive tax deductions equal to the carrying amount of the lease liability (CU435). The tax base of the related component of the lease asset's cost is also nil because Lessee will receive no tax deductions from recovering the carrying amount of that component of the lease asset's cost (CU435).

The differences between the carrying amounts of the lease liability and the related component of the lease asset's cost (CU435) and their tax bases of nil result in the following temporary differences at the commencement date:

- (a) a taxable temporary difference of CU435 associated with the lease asset; and
- (b) a deductible temporary difference of CU435 associated with the lease liability.

The exemption from recognising a deferred tax asset and liability in paragraphs 15 and 24 does not apply because the transaction gives rise to equal taxable and deductible temporary differences. Lessee concludes that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised. Accordingly, Lessee recognises a deferred tax asset and a deferred tax liability, each of CU87 (CU435 × 20%), for the deductible and taxable temporary differences.

### Summary of recognised deferred tax

The table below summarises the deferred tax that Lessee recognises on initial recognition of the lease (including the advance lease payment and initial direct costs):

	Carrying amount	Tax base	Deductible / (taxable) temporary difference	Deferred tax asset / (liability)
Lease asset				
– advance lease payment	15	—	(15)	(3)
– initial direct costs	5	—	(5)	(1)
– the amount of the initial measurement of the lease liability	435	—	(435)	(87)
Lease liability	435	—	435	87

Applying paragraph 22(b) of IAS 12, Lessee recognises deferred tax assets and liabilities as illustrated in this example and recognises the resulting deferred tax income or expense in profit or loss.