Recognition of Deferred Tax Assets for Unrealised Losses

(Amendments to LKAS 12)

CONTENTS

Amendments to LKAS 12 *Income Taxes*

Paragraph 29 is amended and paragraphs 27A, 29A and 98G are added. An example following paragraph 26 is also added. New text is underlined. Paragraphs 24, 26(d), 27 and 28 have not been amended but are included for ease of reference.

Deductible temporary differences

24 **A deferred tax asset shall be recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised, unless the deferred tax asset arises from the initial recognition of an asset or liability in a transaction that:**

(a) is not a business combination; and

(b) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

However, for deductible temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, a deferred tax asset shall be recognised in accordance with paragraph 44.

…

26 The following are examples of deductible temporary differences that result in deferred tax assets:

(a) …

(d) certain assets may be carried at fair value, or may be revalued, without an equivalent adjustment being made for tax purposes (see paragraph 20). A deductible temporary difference arises if the tax base of the asset exceeds its carrying amount.

<u>Example illustrating paragraph 26(d)</u>

<u>Identification of a deductible temporary difference at the end of Year 2:</u>

<u>Entity A purchases for RS. 1,000, at the beginning of Year 1, a debt instrument with a nominal value of RS. 1,000 payable on maturity in 5 years with an interest rate of 2% payable at the end of each year. The effective interest rate is 2%. The debt instrument is measured at fair value.</u>

<u>At the end of Year 2, the fair value of the debt instrument has decreased to RS. 918 as a result of an increase in market interest rates to 5%. It is probable that Entity A will collect all the contractual cash flows if it continues to hold the debt instrument.</u>

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Example illustrating paragraph 26(d)

Any gains (losses) on the debt instrument are taxable (deductible) only when realised. The gains (losses) arising on the sale or maturity of the debt instrument are calculated for tax purposes as the difference between the amount collected and the original cost of the debt instrument.

Accordingly, the tax base of the debt instrument is its original cost.

The difference between the carrying amount of the debt instrument in Entity A's statement of financial position of RS. 918 and its tax base of Rs. 1,000 gives rise to a deductible temporary difference of Rs. 82 at the end of Year 2 (see paragraphs 20 and 26(d)), irrespective of whether Entity A expects to recover the carrying amount of the debt instrument by sale or by use, ie by holding it and collecting contractual cash flows, or a combination of both.

This is because deductible temporary differences are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base that will result in amounts that are deductible 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). Entity A obtains a deduction equivalent to the tax base of the asset of RS. 1,000 in determining taxable profit (tax loss) either on sale or on maturity.

27 The reversal of deductible temporary differences results in deductions in determining taxable profits of future periods. However, 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. Therefore, an entity recognises deferred tax assets only when it is probable that taxable profits will be available against which the deductible temporary differences can be utilised.

27A When an entity assesses whether taxable profits will be available against which it can utilise a deductible temporary difference, it considers whether tax law restricts the sources of taxable profits against which it may make deductions on the reversal of that deductible temporary difference. If tax law imposes no such restrictions, an entity assesses a deductible temporary difference in combination with all of its other deductible temporary differences. However, if tax law restricts the utilisation of losses to deduction against income of a specific type, a deductible temporary difference is assessed in combination only with other deductible temporary differences of the appropriate type.

28 It is probable that taxable profit will be available against which a deductible temporary difference can be utilised when there are sufficient taxable temporary differences relating to the same taxation authority and the same taxable entity which are expected to reverse:

(a) in the same period as the expected reversal of the deductible temporary difference; or

(b) in periods into which a tax loss arising from the deferred tax asset can be carried back or forward.

In such circumstances, the deferred tax asset is recognised in the period in which the deductible temporary differences arise.

29 When there are insufficient taxable temporary differences relating to the same taxation authority and the same taxable entity, the deferred tax asset is recognised to the extent that:

(a) it is probable that the entity will have sufficient taxable profit relating to the same taxation authority and the same taxable entity in the same period as the reversal of the deductible temporary difference (or in the periods into which a tax loss arising from the deferred tax asset can be carried back or forward). In evaluating whether it will have sufficient taxable profit in future periods, an entity:

(i) compares the deductible temporary differences with future taxable profit that excludes tax deductions resulting from the reversal of those deductible temporary differences. This comparison shows the extent to which the future taxable profit is sufficient for the entity to deduct the amounts resulting from the reversal of those deductible temporary differences.

(ii) ignores taxable amounts arising from deductible temporary differences that are expected to originate in future periods, because the deferred tax asset arising from these deductible temporary differences will itself require future taxable profit in order to be utilised.

(b) tax planning opportunities are available to the entity that will create taxable profit in appropriate periods.

29A The estimate of probable future taxable profit may include the recovery of some of an entity's assets for more than their carrying amount if there is sufficient evidence that it is probable that the entity will achieve this. For example, when an asset is measured at fair value, the entity shall consider whether there is sufficient evidence to conclude that it is probable that the entity will recover the asset for more than its carrying amount. This may be the case, for example, when an entity expects to hold a fixed-rate debt instrument and collect the contractual cash flows.

…

Effective date

…

98G *Recognition of Deferred Tax Assets for Unrealised Losses* (Amendments to LKAS 12), issued in September 2016, amended paragraph 29 and added paragraphs 27A, 29A and the example following paragraph 26. An entity shall apply those amendments for annual periods beginning on or after 1 January 2017. Earlier application is permitted. If an entity applies those amendments for an earlier period, it shall disclose that fact. An entity shall apply those amendments retrospectively in accordance with LKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. However, on initial application of the amendment, the change in the opening equity of the earliest comparative period may be recognised in opening retained earnings (or in another component of equity, as appropriate), without allocating the change between opening retained earnings and other components of equity. If an entity applies this relief, it shall disclose that fact.

Amendments to the Illustrative examples on LKAS 12 *Income Taxes*

Example 7—Debt instruments measured at fair value is added. New text is underlined.

Example 7—Debt instruments measured at fair value

Debt instruments

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

Debt Instrument	**Cost (Rs.)**	**Fair value (Rs.)**	**Contractual interest rate**
A	2,000,000	1,942,857	2.00%
B	750,000	778,571	9.00%
C	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 SLFRS 9 *Financial Instruments* (or LKAS 39 *Financial Instruments: Recognition and Measurement*[2]).

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.

[2] SLFRS 9 would replace LKAS 39.SLFRS 9 applies to all items that were previously within the scope of LKAS 39

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 Rs. 50,000 and deductible temporary differences of Rs. 430,000, 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 RS. 200,000 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.

Temporary differences

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

	Carrying amount (Rs.)	**Tax base (Rs.)**	**Taxable temporary differences (Rs.)**	**Deductible temporary differences (Rs.)**
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 LKAS 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:

	(Rs.)
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 RS. 78,571

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:

	(Rs.)
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)
Probable taxable profit excluding tax deductions for assessing utilisation of deductible temporary differences in 20X2	208,572
Remaining deductible temporary differences to be assessed for utilization from Step 1	408,572
Utilisation because of future taxable profit (Step 2)	208,572
Utilisation because of the reversal of taxable temporary differences (Step 1)	78,571
Total utilisation of deductible temporary differences	287,143

The tax loss of Rs. 200,000 includes the taxable economic benefit of RS. 2 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 Rs. 208,572. Consequently, the total utilisation of deductible temporary differences amounts to Rs. 287,143 (Rs. 78,571 (Step 1) + Rs. 208,572 (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:

	(Rs.)
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.