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IAS 12 proposals – Recognising deferred tax on leases

Narrower application of IAS 12's initial recognition exemption would improve comparability

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"The proposed amendments would result in the tax accounting better reflecting the economics of the transaction in which the asset and the liability are integrally linked."

Fred Versteeg
KPMG's global IFRS income tax leader

Proposals reaffirm the underlying principle of IAS 12, which is to reflect future tax consequences of transactions or events

- Diversity in application of IAS 12's current initial recognition exemption
- Narrow-scope amendment would limit its application
- Effective tax rate may change
- Have your say – Comment deadline is 14 November 2019

There is currently diversity in practice for the accounting of deferred tax on transactions that involve the recognition of an asset and a liability with a single tax treatment related to both. For example:

- in many jurisdictions, there is one tax deduction for a lease involving the recognition of a right-of-use asset and corresponding lease liability under IFRS 16 *Leases*[1]; or
- in some jurisdictions, there may be one tax deduction on a cash basis for a decommissioning expenditure which is recognised as a decommissioning provision and a corresponding adjustment to the cost of property, plant and equipment[2].

This diversity – and the potential implications now that IFRS 16 is effective – have prompted the International Accounting Standards Board (the Board) to propose a **narrow-scope amendment** to the application of the initial recognition exemption in IAS 12 *Income Taxes*.

Diversity in application of IAS 12's initial recognition exemption

At present, when a company recognises a lease asset and lease liability, for example, it either:

- applies the initial recognition exemption (IRE) separately to the lease asset and lease liability and recognises the tax impacts in profit or loss when they are incurred – i.e. does not reflect the future tax impacts of leases (Approach 1); or

1. IFRS 16 is effective for annual periods beginning on or after 1 January 2019.
2. The proposed amendments have been explained using leases as an example; they would also apply to the recognition of decommissioning liabilities and corresponding adjustment to the asset.

– reflects the future tax impacts of leases and recognises deferred tax (Approach 2). When recognising deferred tax a company may have assessed the lease asset and lease liability together as a single or 'integrally linked' transaction and assessed the net temporary difference.

In essence, some companies reflect the future tax impacts of leases in their financial statements, whilst others do not. This existing diversity reduces comparability between companies and impairs the usefulness of the information for users of the financial statements.

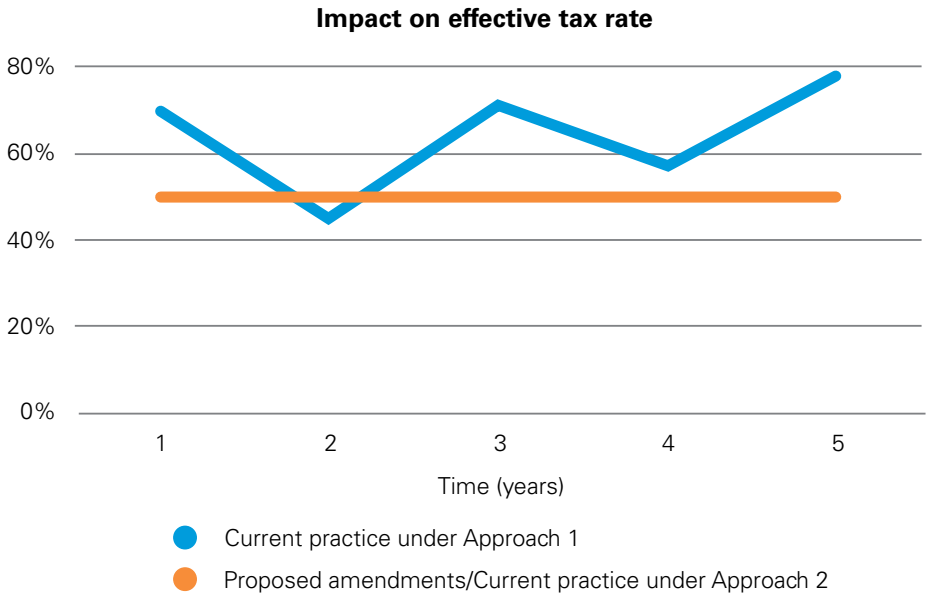
Narrow-scope amendment to IRE proposed

The Board is proposing to limit the application of the IRE. This means that the IRE would not apply when a company recognises equal amounts of deferred tax assets and liabilities from a single transaction. More specifically, a company would not apply the IRE on initial recognition of a lease (or a decommissioning liability and its corresponding asset). Instead, it would generally recognise deferred tax on the temporary differences that arise on initial recognition.

Effective tax rate may change

The potential impact of the proposed amendments depends upon a company's current approach to deferred tax accounting for a lease asset and lease liability. If it recognises deferred tax as it recovers (or settles) the associated lease asset and liability – as set out in Approach 2 above – then the impact in the primary financial statements is unlikely to be significant, although disclosures could be affected. However, for a company that follows Approach 1 and applies the IRE to lease assets and liabilities separately, recognising deferred tax could result in an increase in assets and liabilities and a change in the effective tax rate.

Our **worked example** illustrates how the proposed amendments would apply in practice and the effect on the effective tax rate. As illustrated below, the effective tax rate under the proposed amendments – i.e. where deferred tax is recognised on the lease asset and liability – will be less volatile and reflect the economics of the lease more closely.



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The proposed amendments would apply retrospectively but some relief from assessing deferred tax asset recoverability would be available.

The proposals are open for comment until 14 November 2019 and we encourage preparers and users to share their views with the Board.

For more information on the proposals, speak to your KPMG contact.

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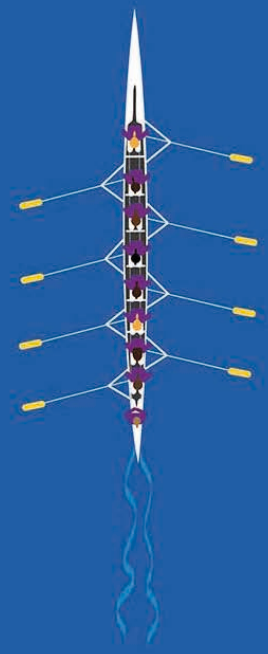

Worked example

Fact pattern:

Lessee T rents a building from Lessor L for five years commencing on 1 January 2019. On 1 January 2019, the right-of use asset[1] and the lease liability under IFRS 16 are CU 435. T's tax rate is 50%.

On initial recognition of the lease, T would recognise the following.

	Debit	Credit
Right-of-use asset	435	
Lease liability		435

How should T account for the income tax impact of the transaction?

Read on for our step-by-step approach.

1. A lessee may also recognise advance lease payments and initial direct costs incurred as part of the cost of the right-of-use asset. These payments do not give rise to equal and offsetting temporary differences. A lessee would account for the tax impacts of such payments separately by applying the existing requirements in IAS 12.

Applying the proposed amendments on initial recognition of a lease

Step 1: Determine if the tax deductions are attributed to the lease asset or lease liability

If the tax deductions are attributed to the lease asset, then no temporary differences arise on initial recognition as follows.

	Carrying amount	Tax base	Taxable (deductible) temporary difference
Right-of-use asset	435	435	–
Lease liability	(435)	(435)	–

If the tax deductions are attributed to the lease liability, then the following temporary differences arise on initial recognition.

	Carrying amount	Tax base	Taxable (deductible) temporary difference
Right-of-use asset	435	–	435
Lease liability	(435)	–	(435)

Step 2: If the tax deductions are attributed to the liability, recognise deferred tax on initial recognition

On initial recognition, T would recognise the following tax impacts[2].

	Debit	Credit
Deferred tax asset	217.5	
Deferred tax liability		217.5

Step 3: Presentation of deferred taxes

T would consider the offsetting requirements in paragraph 74 of IAS 12 for deferred taxes when presenting the tax impacts in the statement of financial position.

2. In this example, T determines that all taxable and temporary differences will reverse in the same period and deferred tax assets are recoverable.