Amendment to IAS 12 - Deferred tax related to assets and liabilities arising from a single transaction

What is the issue?

In May 2021, the IASB issued amendments to IAS 12 *Income Taxes* in order to address potential issues of inconsistency and interpretation by users in respect of the initial recognition exemption ("IRE") detailed in paragraphs 15 and 24 (for deferred tax liabilities and assets respectively).

- The amendments introduce an exception to the initial recognition exemption in IAS 12.
- Applying this exception, an entity does not apply the initial recognition exemption for transactions that give rise to equal taxable and deductible temporary differences.
- The amendments apply to transactions that occur on or after the beginning of the earliest comparative period presented.
- The amendments also apply to taxable and deductible temporary differences associated with right-of-use assets and lease liabilities, and decommissioning obligations and corresponding amounts recognised as assets at the beginning of the earliest comparative period presented.
- The amendments are effective for annual reporting periods beginning on or after 1 January 2023. Early application of the amendments is permitted.

Current accounting treatment

The IRE was initially included within IAS 12 to prevent a lack of reporting transparency for transactions which are not business combinations and, at the time of the transaction, do not affect either accounting or taxable profits. Under this exemption, deferred tax assets/liabilities would neither be recognised at initial recognition of the underlying asset/liability, nor subsequently:

Example 1

Entity X. purchases an intangible asset in cash for $1,200 which is permanently non-deductible for tax purposes (applicable tax rate 15%). Upon initial recognition the entries recorded would be:

Journal 1

Dr Intangible asset additions $1,200

Cr Cash at bank $1,200

Journal 2

Dr ??? $180

Cr deferred tax liability $180

As explained in IAS 12, paragraph 22(c), in the absence of the IRE, entities would essentially gross-up the balance sheet in the above example: recognising a deferred tax liability and increasing the intangible asset's value. This would lead to an overall nil effect on net assets/P&L, but therein creating more "noise" in the financial statements which is deemed to reduce their understandability.

However, in practice, there has been a divergence in treatment of the deferred tax balances relating to transactions which – at the time of the transaction – give rise to equal and offsetting temporary differences (e.g. decommissioning provisions):

Interpretation	Resulting deferred tax accounting
Apply the IRE separately to both the asset and liability	No deferred tax recognised – tax impacts felt in the P&L in the period they are incurred
Assess the asset and liability together – as part of an "integrally-linked" transaction for deferred tax purposes	The recognition of deferred taxes, no IRE applies

The amendments

Additional exclusions have been added to the IRE, detailed in paragraphs 15(b)(iii) and 24(c) for deferred tax liabilities and assets respectively. The effects of these amendments essentially mean that the IRE is not available for transactions which involve the recognition of both an asset and liability – which in turn leads to equal and opposite temporary differences – such that deferred taxes are calculated and booked for both temporary differences, both at initial recognition and subsequently.

In conclusion, under the amendments, an entity does not apply the initial recognition exemption for transactions that give rise to equal taxable and deductible temporary differences.

Transitional provisions

An entity applies the amendments to transactions that occur on or after the beginning of the earliest comparative period presented.

In addition, at the beginning of the earliest comparative period an entity recognises:

- A deferred tax asset (to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised) and a deferred tax liability for all deductible and taxable temporary differences associated with:
  - Right-of-use assets and lease liabilities
  - Decommissioning, restoration and similar liabilities and the corresponding amounts recognised as part of the cost of the related asset
- The cumulative effect of initially applying the amendments as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at that date

Example 2
Entity X recognised a provision for the decommissioning of a nuclear plant in 2011 for $45,000,000; it capitalized the associated expenses as an asset and depreciated this over the 60-year expected period of use until decommissioning is required. The tax rules allow for deduction of these expenses on a cash basis. At the time of the transaction, Entity X applied the IRE to both the asset and liability separately, therefore, no deferred tax has ever been accounted for in relation to this transaction. The appropriate annual discount rate for the provision was deemed to be 6%. The table below shows the associated carrying values of the provision and asset at relevant dates:

Date	Carrying value of provision $m	Deferred tax asset at 20% $m	Carrying value of asset $m	Deferred tax liability at 20% $m
1 January 2011	45.0	9.0	45.0	9.0
1 January 2022	85.4	17.1	36.8	7.4

Entity X adopts the IAS 12 amendments[1] in its financial statements for the year ended 31 December 2023, with the beginning of the earliest period presented being 1 January 2022. The required accounting entry on the date of transition (1 January 2022) is:

Dr deferred tax asset $17.1m

Cr deferred tax liability $7.4m

Cr retained earnings $9.7m

If Entity X had, instead, previously recognised deferred tax on a net basis (i.e. assessed the temporary differences net), then, brought forward, as at 1 January 2022 it would already be carrying a deferred tax asset of $9.7m. In which case, the required accounting entry on transition (1 January 2022) is:

Dr deferred tax asset $7.4m

Cr deferred tax liability $7.4m

i.e. there would be nil impact on opening retained earnings.

1 Deferred Tax related to Assets and Liabilities arising from a Single Transaction (Amendments to IAS 12)

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