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Amendments to HKAS 12 – *Recognition of Deferred Tax Assets for Unrealised Losses*

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MAIN FEATURES

- The amendments are issued with the aim to clarify the requirements on recognition of deferred tax assets for unrealised losses on debt instruments measured at fair value.
- The amendments are to be applied retrospectively.
- Effective for annual periods beginning on or after 1 January 2017, with earlier application permitted.

Background

In January 2016, the International Accounting Standards Board ("IASB") has issued amendments to International Accounting Standard ("IAS") 12 in order to provide guidance on determination 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. Changes in the market interest rate result in a decrease in the fair value of the debt instrument to below its cost (i.e. it has an "unrealised loss");

(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 gain 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.

Subsequently in June 2016, the Hong Kong Institute of Certified Public Accountants also issued the same amendments, Amendments to Hong Kong Accounting Standard ("HKAS") 12 – *Recognition of Deferred Tax Assets for Unrealised Losses*, so as to maintain the convergence with International Financial Reporting Standards.

What are the major content of the amendments?

The amendments are issued to clarify the requirements on recognition of deferred tax assets for unrealised losses on debt instruments measured at fair value. The clarification is summarised as follow:

(a) *Does the carrying amount of a debt instrument measured at fair value below its cost give rise to a deductible temporary difference?*

Paragraph 26(d) of HKAS 12 stated 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. Consequently, 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 holding it until maturity. An example is explicitly added after paragraph 26 of HKAS 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.

(b) *When an entity assesses whether taxable profits will be available against which the deductible temporary differences can be utilised, should the entity perform a combined assessment or separate assessment?*

Paragraph 27A of HKAS 12 is newly added to explicitly clarify that an entity has to consider whether tax law restricts the sources of taxable profits against which it may make deductions on the reversal of that deductible temporary difference when assessing whether taxable profits will be available against which a deductible temporary difference can be utilised. If there are no such restrictions, the deductible temporary difference is assessed in combination with all of its other deductible temporary differences. If there are restrictions imposed by tax laws that the utilisation of losses has to be deducted against income of a specific type (e.g. tax law limits the offset of capital losses to capital gains), a deductible temporary difference is assessed in combination only with other deductible temporary differences of the appropriate type.

(c) *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?*

Paragraph 29(a) of HKAS 12 is modified to clarify that when evaluating whether an entity have sufficient taxable profits in the future periods, the deductible temporary differences have to be compared with the future taxable profit that excludes tax deductions resulting from the reversal of those deductible temporary differences, and taxable amounts arising from deductible temporary differences that are expected to originate in future periods should be ignored. Example 7 in Appendix E is newly provided as an illustrative example for the tax impacts on debt instruments measured at fair value.

(d) *Should the carrying amount of an asset to which a temporary difference is related limit the estimate of future taxable profit?*

It is noted 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 amounts 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 estimation of probable future taxable profit, an entity should include 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. Thus, paragraph 29A of HKAS 12 is newly added to clarify to what extent an entity's estimate of future taxable profit includes amounts from recovering assets for more than their carrying amounts. Entities are required 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. Such an example is provided in paragraph 29A of HKAS 12 to enhance the understanding and reduce the arbitrary risk on estimates of future taxable profit.

When will these amendments become effective?

The Amendments to HKAS 12 will become effective for financial statements with annual periods beginning on or after 1 January 2017. Earlier application is permitted. If an entity applies these amendments for an earlier period, it should disclose that fact.

The Amendments to HKAS 12 should be applied retrospectively in accordance with Hong Kong Accounting Standard 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 should disclose that fact.

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