HKFRS / IFRS UPDATE 2021/06

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AMENDMENTS TO HKAS/IAS 12 - DEFERRED TAX RELATED TO ASSETS AND LIABILITIES ARISING FROM A SINGLE TRANSACTION

STATUS

Final

EFFECTIVE DATE

Mandatorily effective for annual reporting periods beginning on or after 1 January 2023, with earlier application permitted.

ACCOUNTING IMPACT

Reduce the scope of the initial recognition exemption in HKAS/IAS 12 such that it does not apply to the initial recognition of an asset or liability which at the time of the transaction, gives rise to equal taxable and deductible temporary differences.

The accounting policies applied by some entities prior to the amendment may already be consistent with these requirements.

BACKGROUND

On 7 May 2021, the IASB issued amendments to IAS 12 - *Deferred Tax related to Assets and Liabilities Arising from a Single Transaction*. These amendments clarify whether the initial recognition exemption applies to certain transactions that often result in both an asset and a liability being recognised simultaneously. Such instances might include the initial recognition of leases from the perspective of a lessee or asset retirement obligations (AROs)/decommissioning liabilities.

The HKICPA published the equivalent amendments to HKAS 12 in June 2021.

EXPLAINING THE AMENDMENTS

What does HKAS/IAS 12 generally require?

Subject to certain recognition requirements for deferred tax assets, HKAS/IAS 12 generally requires entities to recognise:

- Deferred tax assets arising from deductible temporary differences; and
- Deferred tax liabilities arising from taxable temporary differences.

Deductible and taxable temporary differences are the result of differences between the carrying amount of an asset or liability in the statement of financial position and the tax base. The tax base of an asset or liability is the amount attributed to that asset or liability for tax purposes.

Recognising deferred tax assets and liabilities results in a tax charge in the statement of comprehensive income that corresponds to when an entity recognises amounts in the statement of comprehensive income rather than when an amount is included in the determination of taxable profit for tax purposes.

For example, assume Entity A purchases an item of property, plant and equipment (PP&E) for CU500. In Entity A's jurisdiction, that item of PP&E is depreciated for tax purposes over 4 years (CU125 per annum), whereas Entity A depreciates the asset over 5 years (CU100 per annum), as that is the asset's useful economic life in accordance with HKAS/IAS 16. Entity A recognises a deferred tax liability in years 1-4 as the carrying value of the asset exceeds its tax base. The tax rate is 20% in Entity A's jurisdiction. The only other transaction Entity A enters into is a sale in each year of CU700.

Year	Carrying value at end of each year	Tax base at end of each year	Taxable temporary difference	Accounting profit (700 - accounting depreciation)	Taxable profit (700 - tax depreciation)	Current tax expense	Deferred tax effect	Combined tax expense
1	400	375	25	600	575	115	5	120
2	300	250	50	600	575	115	5	120
3	200	125	75	600	575	115	5	120
4	100	-	100	600	575	115	5	120
5	-	-	-	600	700	140	(20)	120

While current tax expense varies over the 5-year period due to differences between accounting and tax depreciation, the combined tax expense is consistent at CU120 per annum due to Entity A recognising a deferred tax asset from years 1-4, which is subsequently reversed in year 5. This reflects the ultimate tax consequences of purchasing the asset in each year that the asset is used, otherwise, tax expense would fluctuate over time due to the different timing of deduction of the asset for accounting and tax purposes. If deferred tax was not recognised, the tax expense of Entity A would fluctuate from CU115 to CU140 despite the difference between accounting and taxable profit only being on account of temporary differences.

What is the initial recognition exemptions (IRE)?

The initial recognition exemption (IRE) is an exception to the requirement to recognised deferred tax assets and liabilities relating to all deductible and taxable temporary differences.

Prior to the amendments, HKAS/IAS 12 required that deferred tax assets and liabilities be recognised for all taxable and deductible temporary differences, except to the extent that the deferred tax asset or liability arises from:

(a) the initial recognition of goodwill; or

(b) the initial recognition of an asset or liability in a transaction which:

  (i) is not a business combination; and

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

If the criteria in the IRE are met, deferred tax is not recognised, regardless of the fact that the carrying amount and tax base of the asset and/or liability differ.

Modifying the earlier example, assume that Entity A purchases an item of property, plant and equipment (PP&E) for CU500. In Entity A's jurisdiction, the government considers the asset to be polluting, therefore, to disincentivise its purchase, that item of PP&E has its tax depreciation 'capped' at 80% of the purchase price (CU400).

At the initial recognition of the asset, its carrying amount (CU500) and tax base (CU400) differ, which meets the definition of a taxable temporary difference, however, the IRE prevents the recognition of a deferred tax liability because:

IRE Criteria	Assessment (all 'yes' responses means the IRE applies)
Does the difference arise from the initial recognition of an asset or liability?	Yes, the purchase of the item of PP&E.
Is the transaction not a business combination?	Yes, the acquisition of the asset does not meet the definition of a business combination.
At the time of the transaction, is neither accounting profit nor taxable profit affected?	Yes, neither accounting profit or taxable profit are affected at the time of the transaction.

Therefore, no deferred tax liability is recognised relating to the item of PP&E.

Why HKAS/IAS 12 was amended?

HKFRS/IFRS 16 requires a lessee to recognise a lease liability and a right-of-use asset (ROU asset) for most leases. Entities must determine the tax base of the lease liability and ROU asset, but in many jurisdictions, the tax deduction for leases relates to the lease liability because amounts are deducted from taxable profit when lease payments are made. In such cases, the carrying amount and tax base of lease liabilities and ROU assets would be as follows (assume that both items are initially recognised at CU500):

Item	Carrying amount	Tax base	Deductible/(taxable) temporary difference
Lease liability	500	-[1]	500
ROU asset	500	-	(500)

If an entity does not apply the IRE to this transaction, equal and offsetting deductible and taxable temporary differences exist, which result in equal deferred tax assets and liabilities. These may be offset in accordance with HKAS/IAS 12 if certain criteria are met. As the ROU asset is depreciated for accounting purposes and lease payments are made, the amounts of the temporary differences will fluctuate.

In 2019, the IASB became aware that there were differing views as to whether the IRE applies to taxable and deductible temporary differences arising when a lessee initially recognises a right-of-use asset and liability arising from a lease. If the IRE was applied, then an entity would not recognise deferred tax either at the initial recognition of the lease or subsequently over the lease term, which would result in the combined income tax charge fluctuating based the availability of deductions of tax purposes rather than the recovery of the items' carrying values over time.

Therefore, the IASB amended the criteria to which the IRE applies by introducing item (iii) below to clarify this point.

Revised Initial Recognition Exemption Criteria

HKAS/IAS 12 requires that deferred tax assets and liabilities be recognised for all taxable and deductible temporary differences, except to the extent that the deferred tax asset or liability arises from:

(a) the initial recognition of goodwill; or

(b) the initial recognition of an asset or liability in a transaction which:

   (i) is not a business combination;

   (ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss); and

   (iii) at the time of the transaction, does not give rise to equal taxable and deductible temporary differences.

In the case of the lease example above, the lease does give rise to equal taxable and deductible temporary differences, therefore, the amendments to HKAS/IAS 12 clarify that the IRE does not apply in this case.

[1] The tax base of a liability is its carrying amount (CU500) less any amount that will be deductible for tax purposes (CU500).

What about lease advance payments and initial direct costs?

The initial carrying amount of lease liabilities and ROU assets may differ due to advance lease payments and/or initial direct costs. For example, modifying the lease example above, assume that the lessee had made an advance lease payment of CU50 and incurred initial direct costs of CU15. The carrying amounts of the lease liability and ROU asset at initial recognition would be:

- Lease liability: 450 (500 - 50 advanced payment)
- ROU asset: 515 (450 + 50 advanced payment + 15 initial direct costs)

Assume that the advance payment and the initial direct costs are deductible for tax purposes when the payments are made.

A new example is included in the amendments to HKAS/IAS 12 to clarify how they should be applied in this circumstance.

The advance payments/initial direct costs are analysed as follows:

Revised IRE Criteria - Advanced payment and initial direct costs	Assessment (all 'yes' responses means the IRE applies)
Does the difference arise from the initial recognition of an asset or liability?	The advance lease payment and initial direct costs arise from the initial recognition of a lease.
Is the transaction not a business combination?	Yes, entering into the lease contract does not meet the definition of a business combination.
At the time of the transaction, is neither accounting profit nor taxable profit affected?	No, taxable profit is affected at the time of the transaction because the advanced payment and initial direct costs are deducted from taxable profit when paid.
At the time of the transaction, does the transaction not give rise to equal taxable and deductible temporary differences?	Not applicable

Therefore, deductible temporary differences of CU65 (CU50 advance payment and CU15 initial direct costs) exist, and a deferred tax liability is recognised because the IRE does not apply.

The lease liability and the related component of the lease asset's cost (ie CU450, the ROU asset apart from the effect of advanced lease payments and initial direct costs) have been analysed as follows:

Revised IRE Criteria – lease liability and ROU asset	Assessment (all 'yes' responses means the IRE applies)
Does the difference arise from the initial recognition of an asset or liability?	The differences arise due to the initial recognition of the lease. Neither the lease liability or the corresponding amount of the lease asset's cost have tax basis.
Is the transaction not a business combination?	Yes, entering into the lease contract does not meet the definition of a business combination.
At the time of the transaction, is neither accounting profit nor taxable profit affected?	Yes, neither accounting profit or taxable profit are affected at the time of the transaction.
At the time of the transaction, does the transaction not give rise to equal taxable and deductible temporary differences?	No, the lease liability and the related component do give rise to equal taxable and deductible temporary differences.

Therefore, taxable and deductible temporary differences of CU450 exist for both the lease liability and the related component of the lease asset's cost, and deferred tax liabilities and assets are recognised because the IRE does not apply.

The lease and its tax effects on initial recognition are summarised as follows (assume a tax rate of 20%):

	Carrying amount	Tax base	Deductible/(taxable) temporary difference	Deferred tax asset/(liability)
Lease asset				
- Advance lease payment	50	-	(50)	(10)
- Initial direct costs	15	-	(15)	(3)
- Amount of the initial measurement of the lease	450	-	(450)	(90)
Lease liability	450	-	450	90

Are leases the only transactions affected by the amendments?

Any transaction that gives rise to equal taxable and deductible temporary differences may be affected by the change in the scope of the IRE. For example, entities might enter into transactions where they acquire an asset and simultaneously incur an obligation to remediate that asset in the future, sometimes referred to as an asset retirement obligation (ARO) or a decommissioning liability. An ARO would be recorded by recognising the liability with the offsetting entry recorded as a component of the cost of the asset acquired.

Which entities might be affected by the amendments?

As noted above, some entities may previously have considered that the IRE applied in these cases. If so, then the amendments will affect those entities.

What are the transitional requirements?

Entities are required to apply the amendments for annual reporting periods beginning on or after 1 January 2023. Earlier application is permitted. If an entity applies the amendments for an earlier period, it is required to disclose that fact.

Entities are required to apply the amendments to transactions that occur on or after the beginning of the earliest comparative period presented (ie from 1 January 2022 for entities providing one year of comparative information). Retrospective application of the amendment is not required, because doing so would require entities to retrospectively assess whether each lease and decommissioning obligation gave rise to equal taxable and deductible temporary differences, which may be onerous.

At the beginning of the earliest comparative period presented, entities are required to recognise deferred tax assets (subject to the recoverability requirements of HKAS/IAS 12) and deferred tax liabilities associated with:

(i) Right-of-use assets and lease liabilities; and

(ii) Decommissioning, restoration and similar liabilities and the corresponding amounts recognised as part of the cost of the related asset.

The effect of recognising these deferred tax items is reflected as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) as at that date.

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