TECHNICAL CIRCULAR:	**8/2021 [TC 8_2021]**
To:	**ALL MEMBERS OF ICPAC**
From:	**Accounting Standards Committee**
Date:	**28 April 2021**
Topic:	**Deferred tax considerations of applying IFRS 9 ECL requirements**

The Technical Circular (TC 6_2021) aims to provide practical guidance regarding the deferred tax implications of applying IFRS 9 Expected Credit Losses (ECLs) requirements. The circular:

1) Provides an overview of the key principles of IFRS 9 ECLs; and

2) Describes the deferred tax considerations of IFRS 9 ECLs, including consideration of the deferred tax implications on losses arising from:
   - ECLs for each stage of IFRS 9 ECL assessment;
   - ECLs under the simplified approach for trade receivables; and
   - ECLs on intercompany balances.

   Entities claiming a tax deduction on the amount of loss arising from financial assets, should make an assessment of the degree of uncertainty arising from their tax positions (i.e. that the tax authorities will make different assumptions upon examination of their tax treatments), as required by IFRIC 23 "Uncertainty over Income Tax Treatments" and determine whether any additional provisions will need to be recognized (IFRIC 23 is mandatory for accounting periods beginning on or after 1/1/2019).

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IFRS 9 ECLs – Key principles

a) Classification & Measurement

This guidance addresses only debt instruments measured at amortised cost. A financial asset is measured at amortised cost if both of the following conditions are met [IFRS 9, para 4.1.2]:

a) the financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows; and

b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

The typical elements[1] of the amortised cost of a financial asset are:

Amount initially recognised	X
Less: Principal payments	(x)
Plus / less: cumulative amortisation using the EIR of any difference between the initial amount and the maturity amount	X / (x)
Gross carrying amount	X
ECLs Loss allowance	(x) / x
Amortised cost	X

b) Impairment

IFRS 9, effective from 1 January 2018, introduced a forward-looking approach for estimating ECLs for debt instruments.

ECLs are recognized and measured according to either of the following 3 approaches:

a) the General Approach;
b) the Simplified Approach; and
c) the Purchased or Originated Credit Impaired (POCI) Approach (less commonly used).

More details concerning the general and the simplified ECLs approaches are provided below.

[1] Other reconciling line items might exist, e.g., foreign exchange differences.

a) General Approach

Under the General Approach, impairment is generally measured as either:

- 12-month ECLs – defined as the 'portion of lifetime expected credit losses that represents the expected credit losses that result from default events on the financial instrument that are possible within the 12 months after the reporting date' (Stage 1); or
- Lifetime ECLs – defined as the 'expected credit losses that result from all possible default events over the expected life of the financial instrument' (Stage 2 [underperforming but not credit-impaired] or Stage 3 [credit-impaired]).

The measurement basis depends on whether there has been a significant increase in credit risk since initial recognition. ECLs are measured as lifetime ECLs if, at the reporting date, the credit risk on the financial instrument has increased significantly since its initial recognition.

At each reporting date, entities are required to determine whether there has been a significant increase in credit risk since initial recognition and whether the debt instrument is credit impaired. This determines whether the debt instrument is classified in Stage 1, Stage 2 or Stage 3, which in turn determines both the amount of ECL to be recognised: 12-month ECL (for Stage 1) or Lifetime ECL (for Stage 2 and 3) and the amount of interest income to be recognized.

Interest income for non-credit impaired debt instruments (for Stage 1 and 2) is calculated by applying the Effective Interest Rate (EIR) on the gross carrying amount whereas for credit-impaired debt instruments (Stage 3) by applying the EIR on the net carrying amount.

b) Simplified Approach

Under the simplified approach an entity is not required to track the changes in credit risk; the loss allowance is always equal to lifetime ECLs. The simplified approach is required for trade receivables and contract assets without a significant financing component, and allowed as a policy choice for lease receivables, trade receivables and contract assets with a significant financing component, independently of each other.

Deferred tax considerations of IFRS 9 ECLs

1. Deferred tax – Key principles

The general requirement of IAS 12 “Income taxes” is that deferred tax is recognised for the estimated future tax effect of temporary differences (subject to certain exemptions), unused tax losses carried forward and unused tax credits carried forward.

A temporary difference is the difference between the carrying amount of an asset or liability in the financial statements and its tax base.

Such a temporary difference will result in taxable or deductible amounts in future periods when the carrying amount is recovered or settled.

Therefore, in determining the amount of deferred tax to recognise, the analysis focuses on the carrying amounts in the statement of financial position rather than on the differences between profit or loss and taxable profits - i.e., it is a 'balance sheet' approach, rather than a 'timing differences' or an 'income statement' approach.

Temporary differences may be either:

- taxable - i.e., they will result in taxable amounts in future periods; or
- deductible - i.e., they will result in tax deductions in future periods [IAS 12.5].

2. General deferred tax considerations for IFRS 9 ECLs

A deferred tax asset (DTA) is generally recognized for all deductible temporary differences to the extent it is probable that future taxable profit will be available against which the deductible temporary difference can be utilized.

The exception is where the DTA arises from the initial recognition of an asset or liability in a transaction that:

- Is not a business combination; and
- Does not affect accounting profit or taxable profit (tax loss) at the time (of the transaction).

If the exception is met, the DTA is not recognized.

When considering the exception for initial recognition exemption of IAS 12, this does not apply as a result of the recognition of ECLs on day one, which impacts accounting profit or loss.

Deferred tax assets (liabilities) are calculated using the following formulas.

$$Temporary\ difference = carrying\ amount - tax\ base$$

$$Deferred\ tax\ asset\ (liability) = temporary\ difference\ X\ tax\ rate$$

Tax base

The tax base of an asset is the total amount of expenses that will be deductible for tax purposes, against any taxable economic benefits that will flow to the entity, when it recovers the carrying amount of the asset [IAS12:7].

$$\begin{aligned} Tax\ base\ of\ an\ asset \\ &= Carrying\ amount - Future\ Taxable\ Amounts \\ &+ Future\ deductible\ amounts \end{aligned}$$

For a debt instrument, the total amount of expenses that will be deductible for tax purposes may be its entire carrying amount, provided that the entity's management believes that the future full or partial write off[2] of a debt instrument will give rise to a tax-deductible expense. This is an important assessment that affects the recognition of a deferred tax asset; hence an entity's management should be in a position to support this assessment.

For example, consider a trade debtor with a carrying amount of EUR4.000 after recognizing a provision of EUR1.000. The tax base of the asset, applying the above formula, assuming that the provision is not deductible until the asset is derecognized, would be:

$$Tax\ base\ of\ the\ trade\ debtor = EUR4.000 - EURnil + EUR1.000 = EUR5.000$$

As explained in Section "IFRS 9 ECLs – Key principles" above, the ECLs loss allowance is an element of the amortised cost of a financial asset (i.e., the carrying amount in the financial statements), as it reduces its gross carrying amount (regardless of whether the asset is Stage 1, 2 or 3). Hence, to assess whether a temporary difference exists, it is necessary to determine the tax base of the asset, by considering the relevant tax rules in the territory.

[2] Write-offs: Per IFRS 9, the gross carrying amount of an asset is reduced ('written-off') when there is no reasonable expectation of recovering the contractual cash flows of a financial asset, either in its entirety or a portion thereof. IFRS 9 does not define the term 'no reasonable expectation' and the assessment may require judgement.

Determine the temporary differences

The DTA is affected by whether the ECLs loss allowance is tax deductible for tax purposes in the year it arises, or if it is deductible in future periods. The ECLs loss allowance could have no impact on the tax base of the debt instrument (for example this may be the case for Stage 1 and Stage 2 ECLs). In cases that the tax base is equal to the gross carrying amount of the debt instrument (refer to previous paragraph), then the ECLs loss allowance will cause its carrying amount (amortised cost) to become lower than its tax base, thus giving rise to a deductible temporary difference, e.g. in the above scenario the deductible temporary difference would be EUR1.000 (EUR4.000- EUR5.000).

Calculate deferred tax

The product of the deductible temporary difference and the tax rate which is enacted or substantially enacted by the period-end (for example currently the 12,5% corporation tax rate), will give rise to a DTA, which will only be recognized if it is probable (more likely than not) that taxable profit will be available against which the deductible temporary difference will be utilised.

Assess the recoverability of deferred tax assets

It should be noted that entities should ensure that deferred tax assets are recognised ONLY when recoverable. This is a very critical and judgmental area.

3. Deferred tax asset on the various stages of a debt instrument's classification

If, for example, ECLs loss allowance on Stage 1 and Stage 2 financial assets is considered not to be a tax-deductible expense in the year in which it arises, then a deductible temporary difference exists and a deferred tax asset is recognised, as explained above.

If, for example, ECLs loss allowance on a Stage 3 financial asset is considered to be a tax-deductible expense in the year it arises, then no temporary difference arises since the tax benefit from the allowance for ECLs will be received in the same year as that the respective expense is recorded.

In general, if the ECLs loss allowance (regardless of the stage) has not been claimed as a tax-deductible expense, then a respective deferred tax asset is recognised to the extent that it is probable that future taxable profits will be available against which the deductible temporary difference can be utilized.

4. ECLs under the simplified approach for trade receivables

A deductible temporary difference may also arise on any trade receivables for which an entity has recognized an allowance for ECLs under the simplified approach, provided that the resulting impairment loss has not been claimed as a tax-deductible expense in the year in which it arose.

5. Allowance for ECLs on intercompany balances

Additional considerations apply when determining whether a deductible temporary difference arises on the ECLs loss allowance of intercompany balances and may require judgement, including as to whether the tax authorities would treat an eventual write-off of an intercompany balance as a tax-deductible expense.

If it is concluded that the ECLs loss allowance will result in tax deductible amounts in future periods when the carrying amount is recovered or settled, then a deferred tax asset is recognised (subject to recoverability) in the same manner as for unrelated debt arrangements explained above. If not, then no deferred tax asset is recognised.