IAS 12 Income Taxes

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Scope of IAS 12

- It accounts for Income taxes and includes
  - All Domestic taxes on taxable profits
  - All Foreign taxes on taxable profits and
  - Withholding taxes payable on distributions

Scope of IAS 12

This Standard does not deal with

- the methods of accounting for government grants
- investment tax credits

However, this Standard does deal with the accounting for temporary differences that may arise from such grants or investment tax credits.

Temporary Differences

- Temporary differences are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base
- Temporary differences may be either
  - Debit balances in the financial statements compared to the tax computations. These will be lead to deferred tax credit balances. These are known as "**taxable** temporary differences"
  - Credit balances in the financial statements compared to the tax computations. These will be lead to deferred tax debit balances. These are known as "**deductible** temporary differences"

Temporary differences may arise

- When income or expense is included in accounting profit in one period but included in the taxable profit in a different period. For example:
  - Situations where the accounting depreciation does not equal tax allowable depreciation; and
  - Items which are taxed on a cash basis but which will be accounted for on an accrual basis.
- Finance leases recognised in accordance with the provision of IAS 17 but which fall to be treated as operating leases under local tax legislation.

Temporary differences may arise

- Revaluation of assets where the tax authorities do not amend the tax base when the asset is revalued.
- The tax base of an item differs from its initial carrying amount. For example, when an entity receives a non-taxable government grant relating to assets.
- Cost of a business combination where the net assets are recognised at their fair values but the tax authorities do not allow adjustment.

Temporary Differences

Examples of temporary differences:

- Tax and book depreciation on fixed assets differs
- Certain income or expense is taxed on a cash basis
- Assets are revalued for book purposes but not for tax purposes
- Fair values are allocated after an acquisition
- Tax base of an asset on initial recognition is different from its carrying amount
- Carrying amount of investments in subsidiaries becomes different from their tax base
- Unutilised losses

Tax Base of an Asset

The tax base of an asset is the amount that will be deductible for tax purposes against the taxable economic benefits that will flow to the entity when it recovers the carrying amount of the asset. If these economic benefits will not be taxable, then the tax base of an asset is equal to its carrying amount, so that no deferred tax arises.

Tax Base of an Asset

Tax Base of an asset

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Future deductible amounts

(**unless** those economic benefits will not be taxable, in which case the tax base of the asset is equal to its carrying amount)

Tax Base of a Liability

Two key rules apply when determining the tax base of a liability. The aim is to identify any incremental tax effect of settling every liability at its carrying value, and if there is no such tax effect, the tax base value is the same as the carrying value.

- The tax base of a liability is its carrying amount, minus any amount that will be deductible for tax purposes in respect of that liability in future periods.

- In the case of revenue received in advance, the tax base is its carrying amount, minus any amount of revenue that will not be taxable in future periods.

Tax Base of a Liability

Tax base of a liability =	Carrying amount - future deductions
	Carrying amount - future nontaxable revenue

Definitions Related to Deferred Tax

	Assets in Statement of financial position	**Liability in Statement of financial position**
Carrying Amount > Tax Bases	**Taxable Temporary Difference (DTL)**	Deductible Temporary Difference (DTA)
Carrying Amount < Tax Bases	Deductible Temporary Difference (DTA)	**Taxable Temporary Difference (DTL)**

Deferred Tax liability

- A deferred tax liability should be recognised for all taxable temporary differences, unless the deferred tax liability arises from:
  - The initial recognition of goodwill or
  - Goodwill for which amortization is not deductible for tax purposes or
  - The initial recognition of an asset or liability in a transaction which
    - Is not a business combination or
    - At the time of the transaction, affects neither accounting profit nor taxable profit.

Deferred Tax liability

Deferred tax liabilities are the amounts of income taxes payable in future periods in respect of taxable temporary differences.

Deferred tax liability = taxable temporary difference x tax rate

Recognizing Deferred Tax Liability

A temporary difference may arise on initial recognition of an asset or liability. The method of accounting for this temporary difference depends on the nature of the transaction which led to the initial recognition:

(a) in a business combination - affects the amount of goodwill

(b) if the transaction affects either accounting profit or taxable profit -resulting deferred tax expense or income in the statement of comprehensive income.

Recognizing Deferred Tax Liability

IAS 12 does not permit an entity to recognize a deferred tax liability or asset arising on initial recognition of an asset or liability acquired other than in a business combination, where the transaction affects neither accounting profit nor taxable profit (loss).

Deferred Tax Asset

Deferred tax assets are the amounts of income taxes **recoverable in future periods** in respect of:

- deductible temporary differences
- the carry forward of unused tax losses, **and**
- the carry forward of unused tax credits

Deferred tax asset = (deductible temporary difference and carry forward of unused tax losses) x tax rate and unused tax credits

Deferred Tax Asset

- A deferred tax asset should be recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary differences can be utilized, unless the deferred tax asset arises from the initial recognition of an asset or liability in a transaction which
  - Is not a business combination and
  - At the time of transaction, affects neither accounting profit nor taxable profit (tax loss).

Example

	Carrying value $ million
Property	10
Plant and equipment	5
Inventory	4
Trade receivables	3
Trade payables	6
Cash	2

Here is how:

	Carrying value	Tax base	Temporary difference
	$m	$m	$m
Property	10	7	3
Plant and equipment	5	4	1
Inventory	4	6	(2)
Trade receivables	3	4	(1)
Trade payables	6	6	-
Cash	2	2	-
			$1m

Therefore, the deferred tax provision will be $1 million × 30% = $300,000.

	Carrying amount	Tax base	Temporary difference	Type tax	Deferred asset + liability @ 30%
Assets					
PPE	2000	1200	800	Taxable	-240.00
Intangibles	400	500	-100	Deductible	+30.00
Held to maturity investments	203.16	203.40	-0.24	Deductible	+0.072
Loans and Receivables	100.77	100.80	-0.03	Deductible	+0.009
			699.73		
Liabilities					
Loans	1000.14	1001	0.86	Taxable	-0.2580
O/s benefits	9.00	0	-9.00	Deductible	+2.700
			8.14		
Deferred tax					207.477

Reviewing Deferred Tax Assets

1. The recoverability of the deferred tax asset is reviewed at each balance sheet date.
2. The carrying amount should be reduced to the extent that it is no longer probable that enough taxable profit will be available to allow the asset to be recovered.
3. Any such reduction should be reversed to the extent that it once again becomes probable that enough taxable profit will exist.

Reviewing Deferred Tax Liabilities

- For deferred tax liabilities and compound financial instruments, IAS 32 Financial Instruments: Presentation requires a compound instrument to be split between debt and equity components. In those jurisdictions, where the tax base of the liability components on initial recognition is equal to the carrying amount of the sum of the liability and equity components, the resulting deferred tax liability is charged directly to the carrying amount of the equity component.

Deferred Tax - Measurement

Deferred tax is measured at the tax rates that are expected to apply in the period when the deferred tax asset is realized or the liability is settled.

The tax must be based on tax rates and laws that have been enacted, or substantively enacted, by the balance sheet date, and it should be based on how the entity expects to recover or settle the asset or liability.

Deferred Tax - Consolidation

In consolidated financial statements, temporary differences are determined by comparing the carrying amounts of assets and liabilities in the consolidated financial statements with the appropriate tax base.

- Foreign Currency translation Reserves
- Inter company Transactions

Offset – Deferred Tax Assets and Liabilities

Deferred tax assets and liabilities should be offset only if the entity meets these two conditions:

- It has a legally enforceable right to set off current tax assets against current tax liabilities.
- The deferred tax assets and liabilities relate to tax levied by the same tax authority on either the same taxable entity or different taxable entities, which intend either to settle current tax liabilities and assets on a net basis, or to realize the assets and settle the liabilities simultaneously, in each future period in which significant amounts of deferred tax liabilities or assets are expected to be settled or recovered.

SIC 21

- Income taxes – recovery of revalued non-depreciable assets
  - SIC 21 deals with cases where a non-depreciable asset is carried at revaluation under IAS 16. No part of the carrying amount of such an asset is considered to be recovered through its use. Therefore, SIC 21 concludes that the deferred tax liability or asset that arises from revaluation must be measured based on the tax consequences that would follow from the sale of the asset rather than through use. In some jurisdictions, this will result in the use of a capital gains tax rate rather than the rate applicable to corporate earnings.

SIC 25

- Income taxes – changes in the tax status of an enterprise or its shareholders
  - A change in the tax status of an enterprise or its shareholders does not give rise to increases or decreases in the pre-tax amounts recognised directly in equity. Therefore, SIC 25 concludes that the current and deferred tax consequences of the change in the tax status should be included in net profit or loss for the period. However, where a transaction or event does result in a direct credit or charge to equity, for example the revaluation of property, plant or equipment under IAS 16, the related tax consequence would still be recognised directly in equity.

About the Author

- *CA. Rajkumar S Adukia is an eminent business consultant, academician, writer, and speaker. He is the senior partner of Adukia & Associates.*

- *In addition to being a Chartered Accountant, Company Secretary, Cost Accountant, MBA, Dip IFR (UK), Mr. Adukia also holds a Degree in Law and Diploma in Labor Laws and IPR.*

- *Mr. Adukia, a rank holder from Bombay University completed the Chartered Accountancy examination with 1st Rank in Inter CA & 6th Rank in Final CA, and 3rd Rank in Final Cost Accountancy Course in 1983.*

- *He started his practice as a Chartered Accountant on 1st July 1983, in the three decades following which he left no stone unturned, be it academic expertise or professional development.*

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About the Author

- *He has been coordinating with various Professional Institutions, Associations, Universities, University Grants Commission and other Educational Institutions.*

- *Authored more than 50 books on a vast range of topics including Internal Audit, Bank Audit, SEZ, CARO, PMLA, Anti-dumping, Income Tax Search, Survey and Seizure, IFRS, LLP, Labour Laws, Real estate, ERM, Inbound and Outbound Investments, Green Audit etc.*

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Thank You