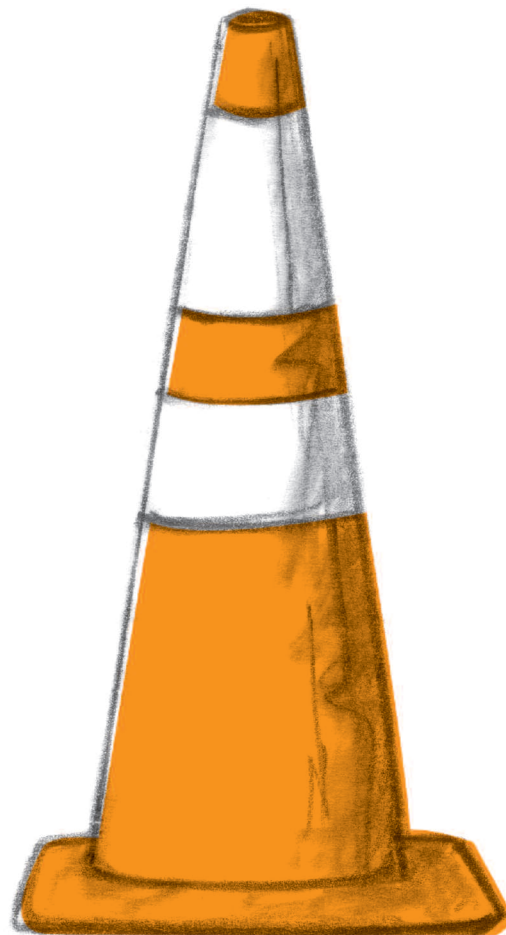


Deferred tax – a Chief Financial Officer’s guide to avoiding the pitfalls



Important Disclaimer:

This document has been developed as an information resource. It is intended as a guide only and the application of its contents to specific situations will depend on the particular circumstances involved. While every care has been taken in its presentation, personnel who use this document to assist in evaluating compliance with International Financial Reporting Standards should have sufficient training and experience to do so. No person should act specifically on the basis of the material contained herein without considering and taking professional advice. Neither Grant Thornton International Ltd, nor any of its personnel nor any of its member firms or their partners or employees, accept any responsibility for any errors it might contain, whether caused by negligence or otherwise, or any loss, howsoever caused, incurred by any person as a result of utilising or otherwise placing any reliance upon this document.

Introduction

Deferred tax

Preparation of financial statements under International Financial Reporting Standards (IFRSs) requires the application of IAS 12 'Income Taxes' (IAS 12). Income taxes, as defined in IAS 12, include current tax and deferred tax. For many finance executives the concepts underlying deferred tax are not intuitive. Applying these concepts also requires a thorough knowledge of the relevant tax laws. IAS 12 takes a mechanistic approach to the computation but also requires significant judgement in some areas. For all these reasons, many Chief Financial Officers (CFOs) find that the calculation of a deferred tax provision causes significant practical difficulties.

Fortunately, the member firms within Grant Thornton International Ltd (Grant Thornton International) – one of the world's leading organisations of independently owned and managed accounting and consulting firms – have gained extensive insights into the more problematic aspects of accounting for deferred taxes under IAS 12. Grant Thornton International, through its IFRS team, develops general guidance that supports its member firms' commitment to high quality, consistent application of IFRS.

We are pleased to share these insights by publishing 'Deferred tax – A Chief Financial Officer's guide to avoiding the pitfalls' (the guide). The guide reflects the collective experience of Grant Thornton International's IFRS team and member firm IFRS experts. It addresses IAS 12's key application issues related to deferred taxes and includes interpretational guidance in certain problematic areas.

Who should read this guide

This guide is intended for CFOs of businesses that prepare financial statements under IFRSs. It illustrates IAS 12's approach to the calculation of deferred tax balances but is not intended to explain every aspect of the standard in detail. Rather, it summarises the approach to calculating the deferred tax balance in order to help CFOs to prioritise and identify key issues. The sections on avoiding the pitfalls will assist in understanding potential problem areas in order to know when to consult further.

The guide has been revised to reflect changes made to IAS 12 up to 31 December 2012.

Grant Thornton International Ltd
February 2013



Contents

Overview of the guide	1
Section 1: Calculating a deferred tax balance – the basics	3
Section 2: Allocating the deferred tax charge or credit	12
Section 3: Disclosures	17
Section 4: Avoiding pitfalls – the manner of recovery and the blended rate	22
Section 5: Avoiding pitfalls – business combinations and consolidated accounts	28
Section 6: Avoiding pitfalls – share-based payments	33
Section 7: Avoiding pitfalls – recognition of deferred tax assets	36
Section 8: Avoiding pitfalls – other issues	40
Appendix A: Glossary	47

Overview of the guide

This guide summarises the approach to calculating a deferred tax balance, allocating the deferred tax charge or credit to the various components of the financial statements, sets out disclosure requirements and provides examples of the disclosures required by the standard. This guide also contains sections which cover some of the more complex areas of preparation of a deferred tax computation, for example the calculation of deferred tax balances arising from business combinations. The sections of the guide are as follows:

Section 1: Calculating a deferred tax balance – the basics

IAS 12 requires a mechanistic approach to the calculation of deferred tax. This section looks at the definitions in the standard and explains, through the use of a flowchart, how to navigate through the requirements of IAS 12.

Section 2: Allocating the deferred tax charge or credit

The second section of this guide summarises the approach to allocating the deferred tax charge or credit for the year to the various components of the financial statements. The deferred tax charge or credit for the year can arise from a number of sources and therefore may need to be allocated to:

- continuing operations within profit or loss
- discontinued operations within profit or loss
- other comprehensive income or equity
- goodwill.

Section 3: Disclosures

IAS 12 contains a number of disclosure requirements. In this section these disclosures are listed and examples of how they can be presented are provided. These disclosures include:

- details of the components of the current and deferred tax charge
- a reconciliation of the total tax charge to the profit multiplied by the applicable tax rate
- details of the temporary differences forming the deferred tax asset or liability
- details of any unprovided deferred tax
- nature of the evidence supporting the recognition of a deferred tax asset.

Section 4: Avoiding pitfalls – the manner of recovery and the blended rate

Some assets or liabilities can have different tax effects depending on the manner in which they are expected to be recovered or settled. For example, the sale of an asset can give rise to a tax deduction, whereas the use of that asset might not give rise to a tax deduction.

The calculation of the deferred tax balance should take into account the manner in which management expects to recover or settle an asset or liability. In many cases this may be obvious, in others it may not, and in others the manner of recovery will be a mix of both use and sale. This section looks at the practical problems associated with calculating the impact on the deferred tax balance based on the expected manner of recovery of an asset.

Section 5: Avoiding pitfalls – business combinations and consolidated accounts

Business combinations and consolidations give rise to complex deferred tax accounting issues. This section considers a number of practical issues that can arise, specifically:

- whether deferred tax should be recognised on intangible assets acquired in a business combination
- when deferred tax arises on assets acquired in a business combination, whether the tax rate to be applied is that of the acquiree or acquirer
- when deferred tax is recognised in a business combination, whether this leads to an immediate impairment of goodwill
- the provision of deferred tax on unrealised intra-group profits eliminated on consolidation.

Section 6: Avoiding pitfalls – share-based payments

This section looks at two particular issues that arise in accounting for deferred tax arising on share-based payments, specifically:

- how to calculate the amount to be recognised in equity and the amount to be recognised in profit or loss
- how to account for deferred tax on share based payments not caught by the measurement provisions of IFRS 2 ‘Share-based Payment’.

Section 7: Avoiding pitfalls – recognition of deferred tax assets

The recognition of deferred tax assets is subject to specific requirements in IAS 12. Deferred tax assets are recognised only to the extent that recovery is probable. This section covers:

- the recoverability of deferred tax assets where taxable temporary differences are available
- the length of ‘lookout periods’ for assessing the recoverability of deferred tax assets
- the recognition of deferred tax assets in interim financial statements.

Section 8: Avoiding pitfalls – other issues

This section is a summary of other issues which can arise in practice, namely:

- whether a particular taxation regime meets the definition of an income tax
- the tracking of temporary differences arising on initial recognition
- the accounting for changes in an asset’s tax base due to revaluation or indexation of that tax base
- the treatment of deferred tax on gains and losses relating to an available-for-sale financial asset reclassified to profit or loss
- accounting for deferred tax on compound financial instruments
- reflecting uncertainty over whether specific tax positions will be sustained under challenge from the relevant tax authorities.

Appendix

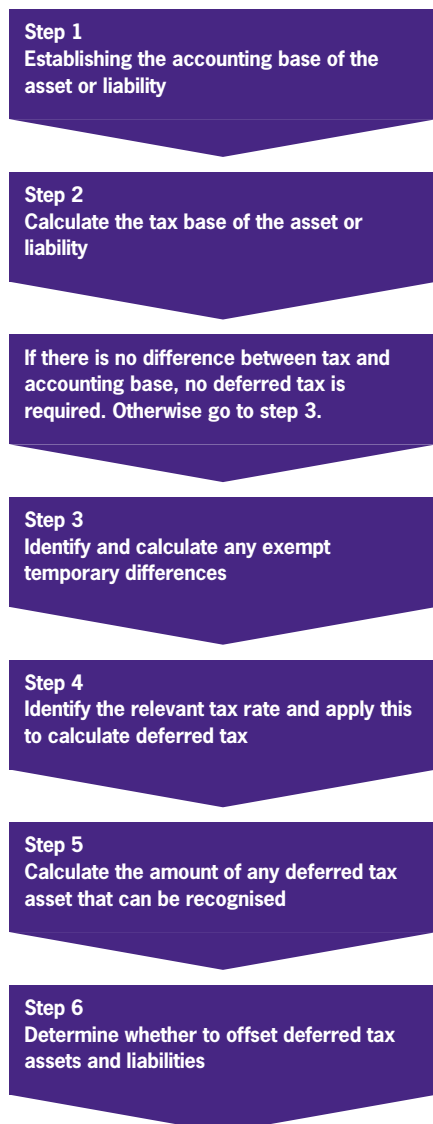
Appendix A to this guide provides a glossary of key terms used in IAS 12.

Section 1: Calculating a deferred tax balance – the basics

Summary of approach

IAS 12 requires a mechanistic approach to the calculation of deferred tax. This section looks at the definitions in the standard and explains, through the use of a flowchart, how to navigate through the requirements of IAS 12.

The following flowchart summarises the steps necessary in calculating a deferred tax balance in accordance with IAS 12.



1.1 What is the accounting base?

Step 1
Establishing the accounting base of the asset or liability

The accounting base of an asset or liability is simply the carrying amount of that asset or liability in the statement of financial position. In most cases, the determination of the accounting base of an asset or liability is straightforward, however IAS 12 requires the calculation of deferred tax to take into account the expected manner of recovery or settlement of assets and liabilities.

In some cases it might be necessary to consider splitting the carrying value of an asset between an amount to be recovered through use and an amount to be recovered through sale. Section 4 contains a further discussion of assets whose carrying amount is recovered through use and sale.

1.2 What is a tax base?

Step 2
Calculate the tax base of the asset or liability

What is the tax base of an asset?

The tax base of an asset is defined as:

‘...the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset. If those economic benefits will not be taxable, the tax base of the asset is equal to its carrying amount’ (IAS 12.7).

What is the tax base of a liability?

The tax base of a liability is defined as:

‘...its carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods. In the case of revenue which is received in advance, the tax base of the resulting liability is its carrying amount, less any amount of the revenue that will not be taxable in future periods’ (IAS 12.8).

Example 1 – the tax base of an asset

Company A purchased an item of property, plant and equipment for CU10,000. Over the life of the asset, deductions of CU10,000 will be available in calculating taxable profit through capital allowances. All deductions will be available against trading income and no deductions will be available on sale. Management intends to use the asset.

As deductions of CU10,000 will be available over the life of the asset, the tax base of that asset is CU10,000.

Tax base of a revalued asset that is not depreciated

When an asset is revalued under IAS 16 ‘Property, Plant and Equipment’ and that asset is non-depreciable, the carrying amount of that asset will not be recovered through use. Therefore the tax base and tax rate will be those applicable to the sale of that asset. IAS 12 was amended in December 2010 to incorporate this principle which was previously contained in SIC-21 ‘Income Taxes-Recovery of Revalued Non-Depreciable Assets’. SIC-21 has been withdrawn as a result of these amendments.

The same presumption, of recovery through sale rather than use, applies to an investment property that is measured at fair value in accordance with IAS 40 ‘Investment Property’. However, in the case of a building the presumption may be rebutted if the building is held in a business model whose objective is to consume substantially all of the economic benefits embodied in the building over time, rather than through sale. For land that meets the definition of investment property, the presumption of recovery through sale may not be rebutted, as land is a non-depreciable asset.

Items with a tax base but no accounting base

Some items have a tax base but no accounting base, for example carried-forward tax losses and some employee share options. Deferred tax on such items is calculated in the same way as items with an accounting base.

Example 2 – an item with a tax base but no accounting base

Company A issues 100,000 share options to its employees. The options vest immediately. A charge is recognised in profit or loss of CU100,000. In the country where Company A is domiciled, a tax deduction will be available when the options are exercised, based on the intrinsic value of the share options at the date of exercise.

As a tax deduction will be available in the future when the options are exercised, a tax base exists, even though no asset is recognised in the statement of financial position for the options issued.

1.3 What is a temporary difference?

Step 3

Identify and calculate any exempt temporary differences

A temporary difference arises whenever the accounting base and tax base of an asset or liability are different. A temporary difference can be either a taxable or deductible temporary difference.

A taxable temporary difference is described in IAS 12.5 as:

'...temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled'

A deductible temporary difference is described in IAS 12.5 as:

'...temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.'

Example 3

Example 3a – a taxable temporary difference

Company A holds an item of property, plant and equipment which has a carrying value of CU7,000 and a tax base of CU4,000 at the reporting date. There is a temporary difference of CU3,000. As the carrying value of the asset is higher than the deductions that will be available in the future, this is, therefore, a taxable temporary difference.

Example 3b – a deductible temporary difference

Company A contributes to a defined contribution pension scheme. At the year end Company A has recognised an accrual of CU5,000. In the country where Company A is domiciled, contributions to the scheme are taxed on a cash basis, the tax base of this liability is nil and there is a temporary difference of CU5,000. As a tax deduction will be available in the future when these contributions are paid to the scheme, this is a deductible temporary difference.

Exempt temporary differences

IAS 12 prohibits the recognition of deferred tax on certain temporary differences. The following explains which temporary differences are exempt under the standard:

Taxable temporary differences

A deferred tax liability should be recognised for all taxable temporary differences. However, IAS 12.15 prohibits the recognition of deferred tax on taxable temporary differences that arise from:

- the initial recognition of goodwill or
- the initial recognition of an asset or liability in a transaction which:
 - is not a business combination and
 - at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

Example 4 – exempt taxable temporary differences

Example 4a – goodwill

Company A purchases Company B. Goodwill of CU150,000 arises on the acquisition. In the country where Company A is domiciled, no tax deduction is available in the future for this goodwill because it only arises in the consolidated financial statements and tax is assessed on the basis of Company A's separate financial statements. There is a taxable temporary difference of CU150,000. However, in accordance with the initial recognition exemption in IAS 12.15 deferred tax is not recognised on that taxable temporary difference.

Example 4b – initial recognition of an asset

Company A purchases an item of property, plant and equipment for CU200,000. In the country where Company A is domiciled, no tax deduction is available for this asset either through its use or on its eventual disposal. There is therefore a taxable temporary difference of CU200,000 on initial recognition of the asset. Assuming that the asset was not purchased in a business combination, the resulting deferred tax liability would not be recognised in accordance with IAS 12.15.

Example 4c – impact of temporary differences arising in a business combination

If the asset above had been recognised in the consolidated financial statements as a result of a business combination, a deferred tax liability would be recognised on the resulting taxable temporary difference. The effect of this would be to increase goodwill by an equal amount.

Deductible temporary differences

A deferred tax asset is recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised.

However, IAS 12.24 prohibits the recognition of a deferred tax asset if that asset arises from the initial recognition of an asset or liability in a transaction that:

- is not a business combination and
- at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

Example 5 – exempt deductible temporary difference

Company A purchases an item of property, plant and equipment for CU100,000. Tax deductions of CU150,000 will be available for that asset in accordance with the tax legislation in the country where Company A is domiciled. There is therefore a deductible temporary difference of CU50,000. As this temporary difference arose on the initial recognition of an asset, that was not acquired as part of a business combination, no deferred tax should be recognised.

Tracking exempt temporary differences

As explained above, IAS 12 prohibits the recognition of deferred tax on temporary differences in certain situations, for example on temporary differences that arise on the initial recognition of goodwill. IAS 12 prohibits the recognition of deferred tax on such temporary differences either on the initial recognition or subsequently (IAS 12.22(c)).

Example 6 – tracking exempt temporary differences

Example 6a – temporary difference arose on initial recognition

In Example 4a above, a taxable temporary difference of CU150,000 arose on the initial recognition of goodwill. As this arose on the initial recognition of the goodwill, no deferred tax was recognised. At the end of the first year after acquisition, an impairment of CU75,000 has been recognised against goodwill.

The carrying value of this goodwill is therefore CU75,000, the tax base is still nil. Therefore, at the year-end there is a taxable temporary difference of only CU75,000. However, this difference is the unwinding of the initial temporary difference and in accordance with IAS 12 no deferred tax is recognised on this temporary difference either on initial recognition of the asset or subsequently.

Example 6b – temporary difference arose after initial recognition

Company A purchases the trade and assets of Company C. Goodwill of CU250,000 arises on the acquisition. In the country where Company A is domiciled, tax deductions of CU250,000 are available in the future on goodwill that arises in the individual company accounts of A. Accordingly, at initial recognition there is no temporary difference.

At the end of the year, no impairment has been charged on this goodwill. In the tax computation for the year, a deduction of CU5,000 has been allowed. The tax base of the goodwill is therefore CU245,000 (CU250,000 – CU5,000). There is therefore a taxable temporary difference of CU5,000 relating to this goodwill.

As this temporary difference did not arise on the initial recognition of goodwill, a deferred tax liability must be recognised. The tracking of initial temporary differences is discussed further in Section 8.2.

Exempt temporary differences on investments in subsidiaries, branches and associates, and interests in joint arrangements

The standard also includes exemptions for recognising deferred tax on temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements.

IAS 12.39 requires an entity to recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, except to the extent that both of the following conditions are satisfied:

- the parent, investor, joint venturer or joint operator is able to control the timing of the reversal of the temporary difference and
- it is probable that the temporary difference will not reverse in the foreseeable future.

IAS 12.44 requires an entity to recognise a deferred tax asset for all deductible temporary differences arising from investments in subsidiaries, branches and associates, and interests in joint arrangements, to the extent that, and only to the extent that, it is probable that:

- the temporary difference will reverse in the foreseeable future and
- taxable profit will be available against which the temporary difference can be utilised.

Example 7 – temporary differences on investments in subsidiaries and associates

Example 7a – taxable temporary difference on investment in subsidiary

Company A purchased Company B on 1 January 20X1 for CU300,000. By 31 December 20X1 Company B had made profits of CU50,000, which remained undistributed. No impairment of the goodwill that arose on the acquisition had taken place. Based on the tax legislation in the country where Company A is domiciled, the tax base of the investment in Company B is its original cost.

In the consolidated accounts of Company A, a taxable temporary difference of CU50,000 therefore exists between the carrying value of the investment in Company B at the reporting date of CU350,000 (CU300,000 + CU50,000) and its tax base of CU300,000. As a parent, by definition, controls a subsidiary it will be able to control the reversal of this temporary difference, for example through control of the dividend policy of the subsidiary. Therefore, deferred tax on such temporary differences is generally not provided unless it is probable that the temporary difference will reverse in the foreseeable future.

In certain jurisdictions, no tax is charged on dividends from investments and on profits from disposal of investments. Therefore, in accordance with the definition of the tax base of an asset and the tax legislation in such jurisdictions, the tax base of such an asset would equal its carrying value. As noted, tax legislation varies from one jurisdiction to another. As such, a detailed understanding of the applicable tax laws is necessary.

Example 7b – probable sale of a subsidiary

Same facts as Example 7a. However, as of 31 December 20X1, Company A has determined that the sale of its investment in Company B is probable in the foreseeable future. For the purpose of this example, the provisions of IFRS 5 'Non-current Assets Held for Sale and Discontinued Operations' are ignored.

The taxable temporary difference of CU50,000 is expected to reverse in the foreseeable future upon Company A's sale of its shares in Company B. This triggers the recording of a deferred tax liability in the consolidated accounts of Company A as of the reporting date. The measurement of deferred tax should reflect the manner in which Company A expects to recover the carrying amount of the investment. Assuming that the capital gains tax rate on sale of shares is 10%, a deferred tax liability of CU5,000 ($CU50,000 \times 10\%$) should be recorded. In determining the appropriate tax rate to use, the legal form of the disposal of the investment (either as sale of the shares or share of the subsidiary's trade and net assets) should be considered as varying tax rates may apply depending on the nature of the transaction. In addition, the legal form of the transaction may affect whether the temporary difference of CU50,000 will, in fact, reverse.

Example 7c – taxable temporary difference on investment in an associate

Company A purchases an interest in Associate C on 1 January 20X2 for CU450,000. By 31 December 20X2 Associate C had made profits of CU75,000 (Company A's share), which remained undistributed. No impairment of the investment in Associate C was required at 31 December 20X2. Based on the tax legislation in the country where Company A is domiciled, the tax base of the investment in Associate C is its original cost.

A taxable temporary difference of CU75,000 therefore exists between the carrying value of the investment in Associate C at the reporting date of CU525,000 ($CU450,000 + CU75,000$) and its tax base of CU450,000. As Company A does not control Associate C it is not in a position to control the dividend policy of Associate C. As a result, it cannot control the reversal of this temporary difference and deferred tax is usually provided on temporary differences arising on investments in associates.

1.4 Calculation of deferred tax – identification of the appropriate tax rate

Step 4 Identify the relevant tax rate and apply this to calculate deferred tax

IAS 12 requires deferred tax assets and liabilities to be measured at the tax rates that are expected to apply in the period in which the asset is realised or the liability is settled, based on tax rates that have been enacted or substantively enacted by the end of the reporting period.

Although it will be clear when a law has actually been enacted, determining whether a tax rate has been substantively enacted by the end of the reporting period following the announcement of a change in the rate is a matter of judgement. The decision should be based on the specific facts and circumstances concerned, in particular the local process for making and amending the tax laws. Some of the factors to be considered include:

- the legal and related processes in the jurisdiction for the enactment of any changes in tax law
- the status of proposed tax changes and the extent of the remaining procedures to be performed and
- whether those remaining procedures are administrative or ceremonial formalities which can be perfunctorily performed.

In 2005, the IASB noted at its February board meeting that it was supportive of the substantive enactment principle on the basis that it would be achieved when the steps remaining in the process will not change the outcome. For example, in certain jurisdictions, substantive enactment is only deemed to occur when the tax bill is signed by the head of state while in others, the government's announcement of the new tax rates may be considered a substantive enactment although formal enactment may occur in a later period.

As the rate to be used is that applicable to the period in which the temporary difference is expected to reverse, some scheduling of the realisation of deferred tax assets and liabilities might be required.

Example 8

Company A is preparing its financial statements for the year ended 30 June 20X1. Company A intends to sell an item of property, plant and equipment which has an associated taxable temporary difference of CU100,000. The tax rate applicable to Company A for the year ended 30 June 20X1 is 24%. Company A expects to sell the property, plant and equipment in 20X2. There is a proposal in the local tax legislation that a new corporation tax rate of 23% will apply from April 1, 20X2. In the country where Company A is domiciled, tax laws and rate changes are enacted when the president signs the legislation. The president signed the proposed tax law on 18 June 20X1.

As the proposed tax law was signed, it is considered to be enacted. Therefore, if Company A expects to sell the asset before the new tax rate becomes effective, a rate of 24% should be used to calculate the deferred tax liability associated with this item of property, plant and equipment. Alternatively, if Company A does not expect to sell the asset until after 1 April 20X2, the appropriate tax rate to use is 23%.

1.5 Recognition of deferred tax assets

Step 5

Calculate the amount of any deferred tax asset that can be recognised

In order to recognise (include in the statement of financial position) a deferred tax asset, there must be an expectation of sufficient future taxable profits to utilise the deductible temporary differences. Economic benefits in the form of reductions in tax payments will flow to the entity only if it earns sufficient taxable profits against which the deductions can

be offset. Therefore, an entity recognises deferred tax assets only when it is probable that taxable profits will be available against which the deductible temporary differences can be utilised.

IAS 12.28-31 contain guidance on when sufficient taxable profits are expected to arise. IAS 12.28 states that it is probable that taxable profit will be available against which a deductible temporary difference can be utilised when there are sufficient taxable temporary differences relating to the same taxation authority and the same taxable entity which are expected to reverse:

- in the same period as the expected reversal of the deductible temporary difference or
- in periods into which a tax loss arising from the deferred tax asset can be carried back or forward.

When there are insufficient taxable temporary differences relating to the same taxation authority and the same taxable entity, a deferred tax asset is recognised to the extent that:

- it is probable that the entity will have sufficient taxable profit relating to the same taxation authority and the same taxable entity in the same period as the reversal of the deductible temporary difference, or in the periods into which a tax loss arising from the deferred tax asset can be carried back or forward or
- tax planning opportunities are available to the entity that will create taxable profit in appropriate periods.

Management will need to use their judgement in estimating whether there will be sufficient taxable profits in the future to recognise a deferred tax asset. Management will also need to make estimates about the expected timing of reversal of the deductible and taxable temporary differences when considering whether a deferred tax asset can be recognised.

Example 9

Example 9a – timing of reversal

At 31 December 20X1, Company A has deductible temporary differences of CU45,000 which are expected to reverse in the next year. Company A also has taxable temporary differences of CU50,000 relating to the same taxable Company and the same tax authority. Company A expects CU30,000 of those taxable temporary differences to reverse in the next year and the remaining CU20,000 to reverse in the year after.

Company A must therefore recognise a deferred tax liability for the CU50,000 taxable temporary differences. Separately, as CU30,000 of these taxable temporary differences are expected to reverse in the year in which the deductible temporary differences reverse, Company A can also recognise a deferred tax asset for CU30,000 of the deductible temporary differences. Whether a deferred tax asset can be recognised for the rest of the deductible temporary differences will depend on whether future taxable profits sufficient to cover the reversal of this deductible temporary difference are expected to arise.

At present both the deferred tax liability and the deferred tax asset must be recognised. Whether this deferred tax asset and deferred tax liability can be offset is considered in the next step.

Example 9b – different types of tax losses

Company A has an item of property, plant and equipment which is expected to be sold. When this asset is sold, a capital tax loss of CU50,000 will crystallise, ie there is an associated deductible temporary difference of this amount. Company A also has taxable temporary differences of CU75,000 associated with its trade operations expected to reverse in the same period as the deductible temporary difference.

In certain jurisdictions, tax authorities may not allow the offset of capital losses against trading profits. Therefore in such cases, in considering whether the deferred tax asset associated with the item of property, plant and equipment can be recognised, the taxable temporary differences associated with Company A's trade operations must be ignored. Hence, in the absence of other information that would allow the offset, a deferred tax liability must be recognised for the CU75,000 of taxable temporary differences and no deferred tax asset can be recognised for the deductible temporary difference.

Unused tax losses and unused tax credits

The general principle in IAS 12 is that a deferred tax asset is recognised for unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised.

The criteria for the recognition of deferred tax assets for unused tax losses and unused tax credits are the same as those arising from deductible temporary differences. However, the standard also notes that the existence of unused tax losses is strong evidence that future taxable profit may not be available. As a result, the standard requires that where an entity has a history of recent losses, the entity recognises a deferred tax asset arising from unused tax losses or unused tax credits only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilised by the entity. This assumes that local tax legislation allows companies to apply unused tax losses and unused tax credits to future taxable profit.

Example 10

At 31 December 20X1, Company A has unused tax losses of CU75,000 and taxable temporary differences of CU25,000 relating to the same taxation authority. Company A has been loss making for the last two years.

In the absence of convincing evidence that there will be sufficient taxable profits against which the deductible temporary differences can be realised, a deferred tax asset is only recognised to the extent of the taxable temporary differences. Therefore a deferred tax asset is recognised for CU25,000 of the unused tax losses and a deferred tax liability is recognised for the CU25,000 taxable temporary differences.

The next step considers whether the resulting deferred tax asset and deferred tax liability should be offset in the statement of financial position.

There is further guidance in Section 7 on assessing whether the recovery of deferred tax assets is probable.

1.6 Offsetting of deferred tax assets and liabilities

Step 6 Determine whether to offset deferred tax assets and liabilities

Deferred tax assets and liabilities are required to be offset only in certain restricted scenarios. Deferred tax assets and liabilities must be recognised gross in the statement of financial position unless:

- the entity has a legally enforceable right to set off current tax assets against current tax liabilities and
- the deferred tax assets and the deferred tax liabilities relate to income taxes levied by the same taxation 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 realise 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.

Example 11

Example 11a – deferred tax asset and liability in the same company

Company A has a recognised deferred tax asset of CU30,000 and a recognised deferred tax liability of CU65,000, both relating to income taxes levied by the same taxation authority. Company A has a right to set off its current tax assets against its current tax liabilities.

Company A should recognise a net deferred tax liability of CU35,000, as the entity has a legally enforceable right to offset current tax assets and liabilities and the deferred tax asset and liability relate to income taxes levied by the same taxation authority on the same taxable entity.

Example 11b – deferred tax asset and liability in different companies in the same group

Company A has a recognised deferred tax asset of CU30,000. Company A has a subsidiary Company B with a recognised deferred tax liability of CU65,000. Company A also has a legally enforceable right to offset current tax assets and liabilities. The recognised deferred tax asset and deferred tax liability both relate to the same taxation authority.

As the deferred tax asset and liability do not relate to the same taxable entity, management must consider whether these taxable entities either intend to settle current tax liabilities and assets on a net basis or to realise the assets and settle the liabilities simultaneously. This will generally not be the case unless Company A and Company B are part of a tax group and where the local tax jurisdiction allows a group of companies to file tax returns on a consolidated basis.

Section 2: Allocating the deferred tax charge or credit

Allocating the deferred tax charge or credit

This section summarises the approach to allocating the deferred tax charge or credit for the year to the various components of the financial statements. Similar principles apply to the allocation of current tax.

IAS 12 requires that the deferred tax effects of a transaction or other event are consistent with the accounting for the transaction or event itself (IAS 12.57). The deferred tax charge or credit for the year can arise from a number of sources and therefore may need to be allocated to:

- continuing operations within profit or loss
- discontinued operations within profit or loss
- other comprehensive income (OCI) or equity
- goodwill

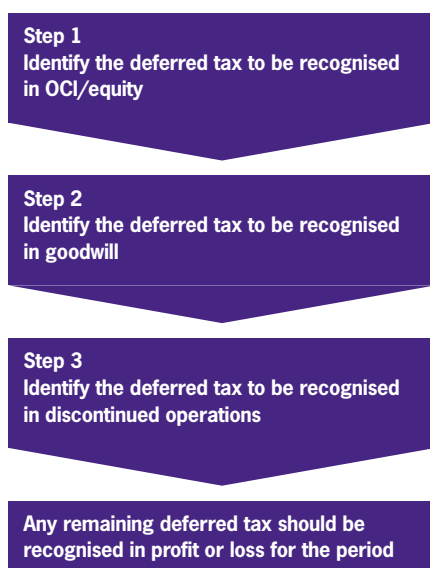
in order to comply with this basic principle.

Flowchart for allocating the deferred tax charge or credit

IAS 12.58 requires that deferred tax should be recognised as income or an expense and included in profit or loss for the period, except to the extent that the tax arises from:

- a transaction or event which is recognised, in the same or a different period, outside profit or loss, either in other comprehensive income (OCI) or directly in equity or
- a business combination.

The flowchart on the following page summarises this requirement diagrammatically. It shows the steps needed to allocate the deferred tax charge or credit to the various components of the financial statements.



2.1 Recognition of deferred tax in OCI or equity

Step 1 Identify the deferred tax to be recognised in OCI/equity

The first step in the flowchart above considers the allocation of deferred tax for items that have been recognised directly in other comprehensive income (OCI) or directly in equity.

IAS 12.61A requires that, where deferred tax arises on items that are recognised outside profit or loss, either in current or prior periods, the related deferred tax should be recognised

outside of profit or loss. IAS 12.61A then expands on this by specifying that:

- deferred tax relating to items recognised in OCI shall be recognised in OCI and
- deferred tax relating to items recognised directly in equity shall be recognised directly in equity.

These requirements are consistent with IAS 12's principle that the deferred tax effects of a transaction or other event is consistent with the accounting for the transaction or event itself.

Examples of items recognised in OCI

Examples of items which are recognised in OCI include:

- re-measurements of the net defined benefit liability, or asset, for defined benefit pension schemes where recognised in OCI
- fair value adjustments on available-for-sale financial assets
- movements on hedging relationships recognised in OCI
- revaluations of property, plant and equipment.

Example 12

On 1 January 20X1 Company A purchases an equity investment for CU6,000. This financial asset is classified, in accordance with IAS 39 'Financial Instruments: Recognition and Measurement' (IAS 39), as an available-for-sale financial asset. At 31 December 20X1, this financial asset has a fair value of CU8,500. The gain on revaluation of this financial asset is taken to OCI in accordance with IAS 39. The financial asset has a tax base equal to its original cost.

The taxable temporary difference of CU2,500 that arises due to the revaluation gives rise to a deferred tax charge in the year of CU575, at a tax rate of 23% (assumed tax rate). The resulting deferred tax charge should be recognised in OCI to match the recognition of the gain that gave rise to this deferred tax charge.

Examples of items recognised directly in equity

Examples of items that are recognised directly in equity include:

- an adjustment to the opening balance of retained earnings resulting from either a change in accounting policy that is applied retrospectively or the correction of an error
- amounts arising on initial recognition of the equity component of a compound financial instrument
- deferred tax on equity-settled share-based payments where the expected future tax deduction is greater than the cumulative share-based payment expense recognised.

Deferred tax on equity-settled share-based payments

IAS 12 contains specific rules on the deferred tax that can arise on equity-settled share-based payments accounted for under IFRS 2 'Share-based Payment' (IFRS 2). In certain tax jurisdictions, a tax deduction is available when share options are exercised. The tax deduction is based on the intrinsic value of those options at the date of exercise (in other jurisdictions, tax deductions may be determined in another way specified by tax law).

The rules in IAS 12.68A-68C cover two main complications that arise with such tax deductions:

- how the tax deduction should be measured at the end of the period and
- where the resulting deferred tax should be recognised.

Measurement of deferred tax

IAS 12.68B requires that if the tax deduction is dependent upon the entity's share price at a future date, the measurement of the deductible temporary difference should be based on the entity's share price at the end of the reporting period.

Component in which to recognise deferred tax

IAS 12.68C requires the deferred tax credit that arises to be recognised in profit or loss unless the expected future tax deduction exceeds the cumulative remuneration charge recognised to date in accordance with IFRS 2. Where the expected future tax deduction is greater than the cumulative share-based payment expense, the deferred tax credit relating to that excess is recognised directly in equity.

Example 13

On 1 January 20X1, Company A issued share options to its employees with a one year vesting period. At 31 December 20X1, an IFRS 2 charge of CU15,000 had been recognised. At 31 December 20X1, the share options expected to be exercised had a total intrinsic value of CU25,000. In the year, a deferred tax credit of CU5,750 should be recognised, based on a tax rate of 23% (assumed tax rate) (CU25,000 × 23%).

At 31 December 20X1, the expected tax deduction of CU25,000 exceeds the cumulative IFRS 2 charge recognised to date of CU15,000 by CU10,000. Therefore, of the tax credit of CU5,750, CU3,450 should be recognised in profit or loss (CU15,000 × 23%) and CU2,300 should be recognised directly in equity (CU10,000 × 23%).

A more extensive example of the deferred tax associated with equity-settled share-based payments is considered in Section 6.

2.2 Deferred tax allocated to business combinations

Step 2 Identify the deferred tax to be recognised in goodwill

Where a deferred tax asset or liability arises on a business combination, a calculation of that deferred tax asset or liability is required at the date of acquisition. This deferred tax asset or liability affects goodwill or bargain purchase gain at the date of the acquisition, in accordance with IAS 12.66.

In summary, the calculation of goodwill in a business combination in accordance with IFRS 3 'Business Combinations' (IFRS 3 (Revised 2008)) requires a comparison of the fair value of the net assets acquired with the fair value of the consideration transferred. Any difference is either recognised as goodwill, to the extent the consideration transferred exceeds the fair value of the net assets acquired, or is recognised immediately in profit or loss, to the extent the fair value of the net assets acquired exceeds the consideration transferred.

The deferred tax asset or liability associated with the net assets acquired is calculated in the same way as other deferred tax assets and liabilities. The deferred tax is not therefore 'fair valued' at the acquisition date. Therefore, if the fair value of the acquired assets and liabilities is different from their tax base, deferred tax will need to be provided on those temporary differences. The resulting deferred tax assets and liabilities will affect the value of the net assets acquired and hence will impact the calculation of any goodwill, or bargain purchase gain.

Example 14

Example 14a – temporary differences arising on acquisition

On 6 June 20X1, Company A acquired Company B for CU50,000. At the date of acquisition, the fair value of the identifiable assets and liabilities of Company B was CU25,000. This included an intangible asset that was not recognised in the individual financial statements of Company B, of CU5,000. The tax base of the assets and liabilities acquired, other than the intangible asset, was equal to their accounting base. The tax base of the intangible asset was nil.

Therefore, a taxable temporary difference of CU5,000 exists at the date of acquisition, and a deferred tax liability of CU1,150 is recognised ($CU5,000 \times 23\%$ (assumed tax rate)). The net assets at the date of acquisition are therefore CU23,850 ($CU25,000 - CU1,150$) and goodwill of CU26,150 ($CU50,000 - CU23,850$) is recognised.

Example 14b – movements in temporary differences associated with business combinations

In the previous example a deferred tax liability of CU1,150 was recognised at the date of acquisition of Company B. The recognition of this deferred tax liability caused the carrying value of goodwill to increase by an equivalent amount at the date of acquisition.

At 31 December 20X1, the intangible asset has been amortised and is now carried in the consolidated statement of financial position at CU4,200. Hence, the deferred tax liability associated with this intangible asset is CU966 ($CU4,200 \times 23\%$). Assuming the amortisation of this intangible asset is recognised in profit or loss, so the movement in the deferred tax liability of CU184 ($CU1,150 - CU966$) is also recognised in profit or loss.

The potential benefit of the acquiree's income tax losses carried forward or other deferred tax assets might not satisfy the criteria for separate recognition when a business combination is initially accounted for but might be realised subsequently. An acquirer is required to recognise acquired deferred tax benefits that it realises after the business combination as follows:

- acquired deferred tax benefits recognised within the measurement period that result from new information about facts and circumstances that existed at the acquisition date shall be applied to reduce the carrying amount of any goodwill related to that acquisition. If the carrying amount of that goodwill is nil, any remaining deferred tax benefits shall be recognised in profit or loss
- all other acquired deferred tax benefits realised shall be recognised in profit or loss (or, if IAS 12 so requires, outside profit or loss).

Entities might have business combinations in which the acquisition date preceded the application of IFRS 3 (Revised 2008). However, where an acquiree's deferred tax asset acquired in a business combination to which IFRS 3 (Revised 2008) was not applied is subsequently recognised in a period in which IFRS 3 (Revised 2008) is applied, the adjustment to deferred tax is recognised in profit or loss with no adjustment to the amount of goodwill originally recognised.

Example 15

On 31 July 20X1, Company A acquired Company C. Company C had trading losses available for deduction against future trading profits of CU50,000 at the date of acquisition. These losses did not qualify for recognition in accordance with IAS 12 at the date of acquisition. At the date of combination, goodwill of CU100,000 was recognised.

On 31 December 20X2, management still did not consider it probable that future taxable profits would be recognised by Company C sufficient to justify recognition of this deferred tax asset.

IFRS 3 (Revised 2008) was applied by Company A for the financial year beginning 1 January 20X3. On 31 December 20X3 management considered it probable that future taxable profits will be recognised by Company C sufficient to justify recognition of this deferred tax asset. Therefore, a deferred tax asset of CU11,500 was recognised ($CU50,000 \times 23\%$ (assumed tax rate)) with an equivalent credit recognised in tax allocated to profit or loss. In accordance with the revised provisions of IAS 12 introduced by IFRS 3 (Revised 2008), no adjustment should be made to goodwill.

Deferred tax assets of the acquirer

As a result of a business combination, the probability of realising a pre-acquisition deferred tax asset of the acquirer may change. An acquirer may consider it probable that it will recover its own deferred tax asset that was not recognised before the business combination. For example, the acquirer may be able to utilise the benefit of its unused tax losses against the future taxable profit of the acquiree. Alternatively, as a result of the business combination it might no longer be probable that future taxable profit will allow the deferred tax asset to be recovered. In such cases, the acquirer recognises a change in the deferred tax asset in the period of the business combination, but does not include it as part of the accounting for the business combination. Therefore, the acquirer does not take it into account in measuring the goodwill or bargain purchase gain it recognises in the business combination accounting.

2.3 Deferred tax allocated to discontinued operations

Step 3 Identify the deferred tax to be recognised in discontinued operations

If there are no discontinued operations then this step can be ignored.

There are no explicit requirements for allocating deferred tax charges or credits between continuing and discontinued operations. However IFRS 5 'Non-current Assets Held for Sale and Discontinued Operations' (IFRS 5) requires a single

amount to be shown on the face of the statement of comprehensive income comprising the total of:

- the post-tax profit or loss of discontinued operations and
- the post-tax gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation.

IFRS 5 also requires this single amount to be disaggregated into the following:

- the revenue, expenses and pre-tax profit or loss of discontinued operations
- the related income tax expense as required by IAS 12.81(h)
- the gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation.

As there is no explicit guidance in IAS 12 on allocating the deferred tax charge or credit between continuing and discontinued operations, management should use their judgement to determine an accounting policy. If material, this judgement will need to be disclosed in accordance with IAS 1 'Presentation of Financial Statements' (IAS 1.122).

2.4 Deferred tax recognised in profit or loss

Any remaining deferred tax should be recognised in profit or loss for the period

Having identified the amount of the movement in deferred tax attributable to business combinations, other comprehensive income, and other elements of equity and discontinued operations, any remaining movement in the net deferred tax asset or liability should be recognised in profit or loss.

Section 3: Disclosures

Disclosures

IAS 12 contains a number of disclosure requirements. In this section these disclosures are listed and examples of how they can be presented are provided.

These disclosures include:

- details of the components of the current and deferred tax charge
- a reconciliation of the total tax charge to the profit multiplied by the applicable tax rate
- details of the temporary differences forming the deferred tax asset or liability
- details of any unprovided deferred tax.

3.1 Disclosures relating to current and deferred tax charge

IAS 12 requires disclosures to support and explain the tax charge. These are detailed below and examples are included.

IAS 12.79 requires the major components of tax expense (income) to be disclosed separately. The major components of tax expense (income) may include (IAS 12.80):

- current tax expense (income)
- any adjustment recognised in the period for current tax of prior periods
- the amount of deferred tax expense (income) relating to the origination and reversal of temporary differences
- the amount of deferred tax expense (income) relating to changes in tax rates or the imposition of new taxes
- the amount of benefit arising from a previously unrecognised tax loss, tax credit or temporary difference of a prior period that is used to reduce current tax expense
- the amount of the benefit from a previously unrecognised tax loss, tax credit or temporary difference of a prior period that is used to reduced deferred tax expense
- deferred tax expense arising from the write-down, or reversal of a previous write-down, of a deferred tax asset
- the amount of tax expense (income) relating to those changes in accounting policies and errors that are included in profit or loss in accordance with IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors', because they cannot be accounted for retrospectively.

An example of this disclosure is given below:

	20X2		20X1	
	CUm	CUm	CUm	CUm
Domestic corporation tax				
Current tax on income for the year	6.4		3.4	
Adjustment in respect of prior years	(2.4)		(1.3)	
		4.0		2.1
Overseas tax				
Current tax on income for the year	42.0		32.3	
Adjustment in respect of prior years	0.7		(0.3)	
		42.7		32.0
Total current taxation		46.7		34.1
Deferred taxation				
Original and reversal of temporary differences		4.5		8.4
Effect of changes in tax rates		0.3		0.2
Total taxation charge		51.5		42.7

IAS 12.81(ab) requires disclosure of income tax relating to each component of other comprehensive income and IAS 12.81(a) requires disclosure of the aggregate current and deferred tax relating to items that are charged or credited directly to equity.

	20X2	20X1
	CUm	CUm
Total current and deferred tax recognised in other comprehensive income:		
On gains and losses on available-for-sale financial assets	(1.5)	(1.0)
On actuarial gains and losses	(22.2)	11.7
On foreign currency translation differences	2.2	0.5
	(21.5)	11.2
Total current and deferred tax recognised directly in equity:		
On equity-settled share-based payments	(0.1)	0.2
	(0.1)	0.2

IAS 12.81(c) requires an explanation of the relationship between tax expense (income) and accounting profit in either or both of the following forms:

- a numerical reconciliation between tax expense (income) and the product of accounting profit multiplied by the applicable tax rate(s), disclosing also the basis on which the applicable tax rate(s) is (are) computed or
- a numerical reconciliation between the average effective tax rate and the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed.

Such a reconciliation might be given in the following form (tax rates are assumed):

	20X2 CUm	20X1 CUm
Profit before tax	176.0	171.0
Income tax using the Company's domestic rate of tax of 23% (20X1: 24%)	40.5	41.0
Effects of:		
Non-taxable and non-deductible items	11.1	1.5
Utilisation of tax losses	(0.2)	(0.4)
Current year losses for which no deferred tax asset has been recognised	3.0	0.4
Change in tax rates	0.3	0.2
Differing tax rates in different jurisdictions	(0.8)	2.1
Over-provided in prior years	(2.4)	(2.1)
Total taxation charge	51.5	42.7

IAS 12.81 also requires disclosure of:

- an explanation of changes in the applicable tax rate(s) compared to the previous accounting period (IAS 12.81(d))
- the amount (and expiry date, if any) of deductible temporary differences, unused tax losses, and unused tax credits for which no deferred tax asset is recognised in the statement of financial position (IAS 12.81(e))
- the aggregate amount of temporary differences associated with investments in subsidiaries, branches and associates and interests in joint arrangements, for which deferred tax liabilities have not been recognised (IAS 12.81(f)).

These disclosures might be given in narrative form as follows:

The standard rate of domestic corporation tax changed from 24% to 23% (assumed tax rate) with effect from 1 April 20X2. There have also been a number of changes to the tax rate in several overseas jurisdictions.

At 31 December 20X2 the group had unused tax losses amounting to CU23 million (20X1: CU20 million) for which no deferred tax asset has been recognised. These tax losses are not expected to expire.

At 31 December 20X2 taxable temporary differences associated with investments in subsidiaries for which no deferred tax liability had been recognised totalled CU2 million (20X1: CU1.5 million).

Discontinued operations

In respect of discontinued operations IAS 12.81(h) requires disclosure of the tax expense relating to:

- the gain or loss on discontinuance
- the profit or loss from the ordinary activities of the discontinued operation for the period, together with the corresponding amounts for each prior period presented.

These disclosure requirements could be met in narrative form as follows:

The income tax charge for the year relating to the discontinued operation's profit for the year was CU5.0 million (20X1: CU3.0 million). In addition, a further tax charge of CU1.5 million arose on the sale of this operation in the current year.

3.2 Disclosures relating to the deferred tax balance

As well as requiring disclosures to support and explain the tax charge, IAS 12 requires disclosures to support and explain the deferred tax asset or liability.

IAS 12.81(g) requires the notes to the financial statements to disclose in respect of each type of temporary difference, and in respect of each type of unused tax losses and unused tax credits:

- the amount of the deferred tax assets and liabilities recognised in the statement of financial position for each period presented
- the amount of the deferred tax income or expense recognised in profit or loss, if this is not apparent from the changes in the amounts recognised in the statement of financial position.

	Balance at 1 January 20X2 CUm	Recognised in continuing operations CUm	Recognised in discontinued operations CUm	Recognised directly in equity CUm	Disposals CUm	Balance at 31 December 20X2 CUm
Non-current assets	(17.5)	(3.2)	(3.0)	-	(1.6)	(25.3)
Inventories	2.3	0.6	-	-	-	2.9
Interest-bearing loans and borrowings	0.6	4.0	-	-	-	4.6
Employee benefits (including share-based payments)	29.4	(7.2)	-	26.4	-	48.6
Tax value of losses carried forward	3.6	3.4	-	-	-	7.0
	18.4	(2.4)	(3.0)	26.4	(1.6)	37.8

	Balance at 1 January 20X1 CUm	Recognised in continuing operations CUm	Recognised in discontinued operations CUm	Recognised directly in equity CUm	Acquisitions/ Disposals CUm	Balance at 31 December 20X1 CUm
Non-current assets	(18.0)	1.3	-	-	(0.8)	(17.5)
Inventories	1.8	0.8	-	-	(0.3)	2.3
Interest-bearing loans and borrowings	0.2	0.4	-	-	-	0.6
Employee benefits (including share-based payments)	55.0	(12.6)	-	(12.8)	(0.2)	29.4
Tax value of losses carried forward	1.3	2.1	-	-	0.2	3.6
	40.3	(8.0)	-	(12.8)	(1.1)	18.4

3.3 Other disclosures

In addition to the disclosures set out above, other disclosures are required in certain specific situations.

These include:

- the amount of income tax consequences of dividends to shareholders of the entity that were proposed or declared before the financial statements were authorised for issue, but are not recognised as a liability in the financial statements (IAS 12.81(i))
- the amount of a deferred tax asset and the nature of the evidence supporting its recognition, when:
 - the utilisation of the deferred tax asset is dependent on future taxable profits in excess of the profits arising from the reversal of existing taxable temporary differences and
 - the entity has suffered a loss in either the current or preceding period in the tax jurisdiction to which the deferred tax asset relates (IAS 12.82).

This disclosure might be given in narrative form as follows:

The directors have recognised a deferred tax asset of CU6 million relating to unused tax losses that are considered to be able to be offset against the company's taxable profits expected to arise in the next accounting period. Management have based their assessment on the latest budget approved by the board which reflects the improved trading performance largely due to the major contract wins discussed in the business review on page x of the annual report.

Also, where income taxes are payable at a higher or lower rate if part or all of the net profit or retained earnings is paid out as a dividend to shareholders of the entity, an additional disclosure is required. Certain jurisdictions have certain tax rules where income tax rates differ between distributed and undistributed profits. In these circumstances, an entity must disclose the nature of the potential income tax consequences that would result from the payment of dividends to its shareholders. In addition, the entity shall disclose the amounts of the potential income tax consequences practicably determinable and whether there are any potential income tax consequences not practicably determinable (IAS 12.82A).

3.4 Additional disclosures in respect of business combinations

The following disclosures are required in the specific situations mentioned below:

- if a business combination causes a change in the amount recognised for the acquirer's pre-acquisition deferred tax asset, the amount of that change and
- if the deferred tax benefits acquired in a business combination are not recognised at the acquisition date but are recognised after the acquisition date, a description of the event or change in circumstances that causes the deferred tax benefits to be recognised.

Section 4: Avoiding pitfalls – the manner of recovery and the blended rate

Avoiding pitfalls – the manner of recovery and the blended rate

Some assets or liabilities can have different tax effects if they are recovered or settled in different ways. For example, in certain jurisdictions the sale of an asset gives rise to a tax deduction whereas the use of that asset might not give rise to a tax deduction.

The calculation of the deferred tax balance should take into account the manner in which management expects to recover or settle an asset or liability. In many cases this may be obvious, in others it may not. In some cases the expected manner of recovery will be a mix of both use and sale. This section looks at the practical problems associated with calculating the impact on the deferred tax balance based on the expected manner of recovery of an asset.

Method of recovery of an asset

Many assets are recovered partly through use and partly by sale. For example, it is common for an investor to hold an investment property to earn rentals for a period and then sell it. Other assets, such as property, plant and equipment and intangible assets are also frequently used in a business for part of their economic life and then sold. When such assets are depreciated, the residual value ascribed to them indicates an estimate of the amount expected to be recovered through sale.

Under IAS 12, the measurement of deferred taxes related to an asset should reflect the tax consequences of the manner in which an entity expects to recover the carrying amount of the asset (IAS 12.51-51A). When the tax rate and the tax base are the same for both use and sale of the asset, the deferred tax does not depend on the manner of recovery and hence no complications arise. In some jurisdictions the tax rate applicable to benefits generated from using a specific asset, the ‘use rate’, differs from the rate applicable to benefits from selling the asset, the ‘sale rate’. Further in certain jurisdictions, tax bases may vary depending on how an entity benefits from a specific asset. In these circumstances, the measurement of deferred taxes should be consistent with the expected manner of recovery of the asset. This principle requires measurement of deferred taxes by reference to:

- the use tax rate and the tax base applicable for the use of the asset to the extent that the entity expects to recover the carrying amount of the asset through use and
- the sale tax rate and the tax base applicable for the sale of the asset to the extent that the entity expects to recover the carrying amount through sale.

Amendments to IAS 12

In December 2010, the IASB published amendments to IAS 12 to provide further guidance on the above principle for revalued non-depreciable assets under IAS 16 ‘Property, Plant and Equipment’ and for investment property that is measured using the fair value model under IAS 40 ‘Investment Property’.

IAS 12.51B states that deferred tax arising from the revaluation of non-depreciable assets under IAS 16 should be measured on the basis of the tax consequences that would follow from the recovery of the carrying amount through sale. This incorporated the consensus reached in SIC-21 into the standard.

For investment property, an entity may expect to rent out the property to earn rental income and then sell it to gain from capital appreciation at some point in the future. Without specific plans for disposal of the investment property, it is difficult and subjective to estimate how much of the carrying amount of the investment property will be recovered through cash flows from rental income and how much of it will be recovered through cash flows from selling the asset. This is particularly so when the carrying amount is measured using the fair value model in IAS 40. To provide a practical approach in such cases, the amendment introduces a presumption that an investment property is recovered entirely through sale (IAS 12.51C). However in the case of a building the presumption may be rebutted if the building is held in a business model whose objectives is to consume substantially all of the economic benefits embodied in the building over time, rather than through sale. For land that meets the definition of investment property, the presumption of recovery through sale may not be rebutted, as the land is a non-depreciable asset.

Dual intention assets

The application of IAS 12.51 is straightforward in situations where an asset will be recovered in its entirety through either use or sale. The measurement of deferred taxes is, however, more complex when an entity has ‘dual intentions’, ie if it intends to first use and then sell the asset. In this case, a measurement approach needs to be adopted that reflects the tax consequences of this dual intention.

IAS 12 does not set out specific guidance on how to determine deferred taxes for ‘dual intention assets’ when different tax rates and/or tax bases apply. One approach used in practice is to calculate temporary differences and measure the resulting deferred taxes using a blended measurement approach.

Methodology for calculating deferred tax on dual intention assets

The procedure for the blended measurement approach can be illustrated as follows:



Step 1

Determine the element of the carrying value of the asset that will be recovered through use and through sale, respectively. For an asset held at depreciated cost, the amount to be recovered on sale should equal the residual value assumed for depreciation purposes, although it should not exceed the carrying value of the asset. The balance, ie the expected future depreciation charges, is the amount expected to be recovered through use.

Step 2

Identify the tax deductions expected to be available in accordance with the expected manner of recovery of the asset to determine the asset’s tax base for use and for sale. In some jurisdictions this may result in a ‘negative’ tax base for a recovery of previous tax allowances, only effective when the asset is sold. In other tax jurisdictions, tax bases may be based on original cost with some tax deductions during the use period and the remaining balance, if any, deductible on sale. The entity then has to split the overall tax base into the parts that are expected to apply for the sale and use of the asset, respectively.

Step 3

Calculate the temporary differences of the asset applicable to its use and the sale elements by subtracting the tax bases from their respective proportions of the asset’s carrying amount.

Step 4

Determine the tax rate(s) applicable to the use and sale of the asset and multiply them by the relevant temporary differences to calculate deferred tax assets and/or deferred tax liabilities for the use and sale element of the asset.

Integrating initial recognition exemptions into the calculation

In implementing dual intentions into the calculation of deferred taxes, initial recognition exemptions need to be taken into consideration. As set out in IAS 12.15(b) and IAS 12.24 respectively, temporary differences arising upon initial recognition of an asset or a liability outside a business combination are not recognised when accounting for deferred taxes. To comply with this exception to the underlying principle in IAS 12, an entity therefore needs to identify temporary differences that exist upon the initial recognition of an asset. This 'exempted' amount is carried forward and continues to affect the amount of deferred taxes recognised in later periods (IAS 12.22(c)). This is also appropriate if the entity uses a blended measurement approach and temporary differences are identified for the use and sale elements of an asset at its initial recognition.

In addition, where deductible temporary differences result from the application of the blended measurement method, the general requirements of IAS 12 apply with regard to the recoverability of deferred tax assets. Any deferred tax liability and recognised deferred tax asset may then qualify to be offset. However, this needs to be determined based on the specific circumstances in accordance with IAS 12.74.

Example 16

On 31 December 20X1, Company A purchases a building which is considered to be an investment property to be accounted for at fair value under IAS 40 'Investment Property'. The initial cost of the building is CU2,000. According to A's investment strategy, A will hold the investment property for 20 years and then sell the asset. A intends to consume substantially all of the economic benefits embodied in the building over time, rather than through sale, and therefore rebuts the presumption in IAS 12.51C. A determines:

- that CU1,800 is expected to be recovered through use and CU200 through sale
- that the Company will not be entitled to any tax deductions during the holding period, thus the use tax base is nil
- any profit from the sale of the asset will be taxed at a capital gains tax rate of 23%, with taxable profits equalling sale proceeds less original cost of the investment property asset and
- A's regular income tax rate of 23% will apply to rental income.

	Carrying amount	Tax base	Initial temporary difference	Tax rate	Deferred tax liability/(asset)
	CU	CU	CU	%	CU
Recovery through use	1,800	0	1,800	23	414
Recovery through sale	200	2,000	(1,800)	23	(414)

In accordance with the initial recognition exemptions, IAS 12.15(b) and IAS 12.24, no deferred taxes are recognised in A's financial statements when the asset is purchased. However, this exemption does not apply if the asset is acquired in a business combination. In a business combination, the potential deferred tax asset relating to the sale element of the carrying amount would need to be tested for recoverability separately from any deferred tax liability before considering offsetting the two amounts.

At 31 December 20X2 the investment property is revalued in accordance with the fair value model of IAS 40. The new carrying amount of the asset is CU2,400, of which Company A expects to recover CU2,200 through use and CU200 through sale. Using the blended measurement method as described above, but considering the initial recognition difference for the use and the sale component of the asset's carrying amount, the computation for deferred taxes is as follows:

	Carrying amount	Tax base	Current temporary difference (A)	Initial temporary difference (B)	Remaining temporary difference (A-B)	Tax rate	Deferred tax liability
	CU	CU	CU	CU	CU	%	CU
Recovery through use	2,200	0	2,200	1,800	400	23	92
Recovery through sale	200	2,000	(1,800)	(1,800)	0	23	0

As a result, a deferred tax liability will be recognised only for the revaluation increase of the asset. The initial recognition difference exemption applies to the remaining temporary differences identified at the reporting date.

The deferred tax expense is recorded in profit or loss, as it relates to a revaluation that is recognised in profit or loss in accordance with IAS 40. If the asset in question were an item of property, plant and equipment for which a revaluation is recognised in other comprehensive income, the deferred tax consequences would also be recognised in other comprehensive income (IAS 12.61A).

Example 17

Company A has been operating an asset since 1 January 20X1, which it originally intended to use until the end of its useful life, initially expected to be twelve years. The asset is currently accounted for under the cost model of IAS 16 'Property, Plant and Equipment', using the straight-line method of depreciation. Originally, the tax deductions available equalled the original cost of the asset at CU1,200 and no initial recognition difference was identified. The tax deductions are available at an annual allowance of 12.5% of the original cost of the asset for eight years. Any capital gains resulting from a sale of the asset will be taxable and have to be calculated at sale proceeds less any unused tax deductions at the date of sale. The use benefits of the asset will be taxed at 20% whereas the sale profit of the asset will be subject to a capital gains tax rate of 40%.

On 1 January 20X4, the Company changes its intentions. As new technical alternatives to the asset become available, the Company now intends to dispose of it by sale and is looking for an adequate replacement. Nevertheless, the asset will be used for two more years, ie until 31 December 20X5, and no immediate plan to sell the asset exists. Company A expects to recover a residual value of CU550 on sale.

Based on the original intentions of Company A, the carrying amount of the asset, its tax base and the resulting deferred tax liability can be projected as follows:

Year	Projection of carrying amount		Tax base projection		Projection of deferred taxes		
	Depreciation	Carrying amount	Tax allowance	Tax base	Temporary difference	Tax rate (use)	Deferred tax liability
	CU	CU	CU	CU	CU	%	CU
20X1	100	1,100	150	1,050	50	20	10
20X2	100	1,000	150	900	100	20	20
20X3	100	900	150	750	150	20	30
20X4	100	800	150	600	200	20	40
20X5	100	700	150	450	250	20	50
20X6	100	600	150	300	300	20	60
20X7	100	500	150	150	350	20	70
20X8	100	400	150	0	400	20	80
20X9	100	300	0	0	300	20	60
20Y0	100	200	0	0	200	20	40
20Y1	100	100	0	0	100	20	20
20Y2	100	0	0	0	0	20	0

At 31 December 20X3, the asset's carrying amount is CU900 and the tax base is CU750, resulting in a deferred tax liability of CU30 as explained above.

As the management of Company A has changed its intentions at the beginning of 20X4, the expected sale at 31 December 20X5 needs to be implemented into a new depreciation schedule as well as the residual value of CU550 that the Company expects to recover on sale. This change in accounting estimate needs to be applied prospectively in accordance with IAS 8.36, thus resulting in an increased depreciation charge of CU175 for the year ending 31 December 20X4 and a carrying amount of CU725 at the reporting date. The revised projection of the asset's carrying amount may be summarised as follows:

Year	Revised projection of carrying amount	
	Depreciation	Carrying amount
	CU	CU
20X3	100	900
20X4	175	725
20X5	175	550

At 31 December 20X4, the change in Company A's intentions regarding the asset is implemented into the deferred tax calculation using a blended measurement approach. The Company expects to recover CU550 of the total carrying amount through the sale of the asset, which therefore should be considered as the sale element of the asset's carrying amount. The use element is the total carrying amount less the sale element CU175 (CU725 – CU550), which is equal to the expected depreciation charge for the asset in its final year of use.

Applying the same methodology to the tax deductions, the tax base for the use element is equal to one year's tax allowance at CU150. The tax base of the sale element is the remaining balance of the tax deductions, which is equal to the initial cost of the asset less tax allowances utilised until the projected date of sale, ie CU450 (CU1,200 – (5 × 150)). Company A therefore needs to recognise a deferred tax liability of CU45 at the end of 31 December 20X4:

	Carrying amount	Tax base	Temporary difference	Tax rate	Deferred tax liability
	CU	CU	CU	%	CU
Recovery through use	175	150	25	20	5
Recovery through sale	550	450	100	40	40
Total	725				45

Any changes in the deferred tax liability should be recognised in profit or loss (IAS 12.58). It should also be noted that the initial recognition exemption does not affect the measurement of the deferred tax liability in this example, as the initial cost of the asset equalled available future tax deductions when the asset was recognised. In addition, the sale of the asset was not originally anticipated by the Company, but has been taken into consideration after the asset's initial recognition.

The above example is a simplification which ignores the impact of indexation. The impact of indexation on the tax base of an asset is discussed in Section 8.3.

Section 5: Avoiding pitfalls – business combinations and consolidated accounts

Avoiding pitfalls – business combinations and consolidated accounts

Business combinations offer an added level of complexity to the reporting of deferred taxes. This section considers a number of practical issues that can arise, specifically:

- whether deferred tax should be recognised on intangible assets acquired in a business combination
- when deferred tax arises on assets acquired in a business combination, whether the tax rate to be applied is that of the acquiree or acquirer
- when deferred tax is recognised in a business combination, whether this leads to an immediate impairment of goodwill
- the provision of deferred tax on unrealised intra-group profits eliminated on consolidation.

5.1 Intangible assets arising on a business combination

IFRS 3 (Revised 2008) requires intangible assets acquired in a business combination to be recognised at their fair value in the consolidated statement of financial position. Tax rules on intangible assets vary from jurisdiction to jurisdiction. Understanding these rules is necessary to identify the tax bases of intangible assets and, accordingly, any temporary difference that may arise. For example, in certain jurisdictions tax is calculated using the separate financial statements of the members of the group, and not the consolidated accounts. Hence, if an asset arises only on consolidation, its tax base will be nil. This is because, the income earned whilst the asset is used will be taxable and there will be no tax deductions available against that income from the use of the asset. Equally, if such an asset were sold, there would be usually no tax deduction on disposal.

This results in a temporary difference equal to the carrying value of the asset on initial recognition in the consolidated accounts. As the intangible asset and the related deferred tax arise on a business combination, the other side of the entry is to goodwill under IAS 12.66, see Section 2.2.

As the intangible asset is amortised, the temporary difference will decrease. The reduction in the deferred tax liability is recognised in profit or loss. The recognition of this deferred tax credit to profit or loss reduces the impact of the amortisation of the intangible asset on profits for the year.

Example 18

Both Companies A and B are domiciled in Country X and pay corporation tax at 23%. Company A prepares IFRS group accounts. In Country X, taxes are calculated based on the separate financial statements of the group entities rather than the consolidated financial statements.

Year 1

On 31 December 20X1, Company A acquires Company B for CU1,000,000. At that time, Company B has net assets of CU500,000. Company A undertakes a fair value exercise and does not identify any fair value adjustments to the recognised net assets of Company B, however it does identify a number of customer contracts that have a total fair value of CU250,000.

In preparing its consolidated accounts, Company A must recognise this identifiable intangible asset and provide deferred tax on the difference between the asset's carrying amount of CU250,000 and tax base of nil. This leads to a deferred tax liability of CU57,500 using the applicable tax rate of 23%.

Therefore in the consolidated accounts of Company A, goodwill is recognised amounting to CU307,500 (CU1,000,000 – CU500,000 – CU250,000 + CU57,500).

Year 2

At 31 December 20X2, the consolidated accounts show accumulated amortisation of CU50,000. Therefore the intangible asset has an accounting base of CU200,000, which is also the taxable temporary difference at 31 December 20X2. There is, therefore, a resulting deferred tax liability of CU46,000 (CU200,000 × 23%). The amortisation of CU50,000 and the reduction in the deferred tax liability of CU11,500 (CU50,000 × 23%) will both be recognised in profit or loss.

5.2 Whose tax rate should be applied to fair value adjustments arising in a business combination?

The tax base of an asset is the amount that will be deductible for tax purposes in future periods (IAS 12.7). The tax base of an asset may depend on whether the asset is intended to be used or sold. As set out in Section 4, it is important to establish how an entity will recover the carrying amount of its assets, because this may affect the tax base and the tax rate to be applied.

When considering the recognition of deferred tax on assets, the principle in IAS 12 is to consider whether the recovery of the asset will lead to future economic benefits that are taxable. Assuming that a group intends to continue to hold the acquired asset and use it to generate taxable profits in the acquired subsidiary, it is the tax rate that applies to that subsidiary's taxable profits that should be used in calculating the relevant deferred tax balance.

Example 19

Company A acquires Company B on 17 October 20X1. Both Company A and B are trading companies, and for the purposes of IFRS 3 this acquisition is treated as an acquisition of B by A. Company A does not pay tax, ie it is subject to a nil rate of tax in its jurisdiction. Company B pays tax at a rate of 23%.

On the acquisition, Company A performs a fair value exercise which identifies an intangible asset with a fair value of CU250,000. This intangible asset has a tax base of nil, ie no deductions will be available against taxable profit as this asset is recovered.

Therefore, as the intangible asset has a carrying value of CU250,000 and a tax base of nil, it has a temporary difference of CU250,000. As the intangible asset relates to the subsidiary, its carrying value will be recovered through that subsidiary making future taxable profits, which will be taxed at a rate of 23%.

Therefore a deferred tax liability of CU57,500 (CU250,000 × 23%) should be provided. The same analysis holds true for other fair value adjustments recognised in a business combination.

5.3 Can the recognition of deferred tax on intangibles create goodwill which is immediately impaired?

In some situations the recognition of deferred tax on an intangible asset acquired in a business combination can result in a goodwill figure which appears to be immediately impaired.

IAS 36 'Impairment of Assets' (IAS 36) requires goodwill to be tested at least annually for impairment. Goodwill is impaired where the recoverable amount of the cash-generating unit (CGU) to which it is allocated is lower than its carrying amount. Recoverable amount is the higher of the value in use and fair value less costs to sell (IAS 36.6 refers to costs of disposal but it has the same meaning as costs to sell).

In calculating value in use, IAS 36.50 states:

'Estimates of future cash flows shall not include:

- a) cash inflows or outflows from financing activities; or
- b) income tax receipts or payments.'

As a result, the value in use calculation cannot include tax cash flows and is, therefore, based on pre-tax cash flows and a pre-tax discount rate. IAS 36.75 separately requires the carrying value of a CGU to be calculated in a manner consistent with the determination of the recoverable amount of that CGU. Hence, to be consistent with the manner in which the recoverable amount is calculated, the deferred tax liability arising in a business combination should not be included in the net assets of the CGU tested for impairment. This can give rise to potential problems as demonstrated by the following example.

Example 20

Company A acquires Company B. Both Company A and B are trading companies, and for the purposes of IFRS 3 this acquisition is treated as an acquisition of B by A.

The fair value of the consideration, all cash, given by Company A is CU1,000. The only identifiable asset in the business combination is an intangible asset with a value of CU1,000. The intangible asset was not recognised in the accounts of Company B. The tax base of that intangible asset is nil and both Company A and Company B pay tax at the rate of 23%. Therefore, there is a taxable temporary difference arising on the recognition of this intangible of CU1,000 and a deferred tax liability of CU230 must be recognised ($CU1,000 \times 23\%$). Thus, this deferred tax liability arises as a result of recognising and fair valuing the identified intangible asset acquired.

This transaction would be recognised in the consolidated financial statements as follows:

	Debit CU	Credit CU
Intangible asset	1,000	
Goodwill (balancing figure)	230	
Cash		1,000
Deferred tax liability		230

Assuming that the fair value of the consideration transferred was arrived at using value in use calculations and that the CU1,000 represented a fair price for the business, the need to exclude the deferred tax liability from the net assets of the CGU will result in an apparent immediate impairment charge of CU230. This is because the value in use calculations to support the purchase price would take account of the expected future tax cash flows. However, as set out above, IAS 36 prohibits the inclusion of tax balances and tax cash flows in the net assets allocated to the CGU and the calculation of its value in use.

The value of the net assets assigned to this CGU is CU1,230, ignoring the deferred tax liability derived above (Intangible asset CU1,000 + Goodwill CU230). As the value in use calculation supported a consideration of CU1,000 there is an apparent impairment of CU230 ($CU1,230 - CU1,000$).

A number of arguments exist to avoid this apparent need for an immediate impairment charge and these are set out below.

Was a fair price paid? Is the CGU's value supported by its fair value less costs to sell?

The assessment of whether goodwill is impaired will depend on the particular circumstances of the business combination. For example, there may be circumstances where the payment for the business does not represent a fair price for the acquired business, in which case an immediate impairment of the goodwill may arise.

The example above assumed that the payment for the acquired business represented a fair price. Given this assumption, it is clear that there should not be an immediate impairment charge because the combined group has not suffered a loss. Indeed, this assumption provides a justification for not recognising this impairment charge.

Given that we have assumed that the CU1,000 is a fair price for the business combination, IAS 36 would determine this as the fair value less costs to sell of the acquired business, if the costs to sell were likely to be immaterial. The recoverable amount would still be CU1,000. However, the net assets of the CGU would include the deferred tax liability, as the fair value less costs to sell calculation is usually a post-tax assessment. There would, therefore, be no immediate impairment charge.

This may help justify the carrying value of the goodwill immediately after acquisition. However, in circumstances where it is difficult to continually monitor the fair value less costs to sell of a CGU, this is unlikely to provide an adequate ongoing solution. Where there is an absence of external transactions against which this valuation might be benchmarked, it may prove difficult to continually monitor the fair value less costs to sell of a CGU, and, therefore, unable to avoid an impairment of goodwill indefinitely.

Does significant headroom exist to justify the carrying value of the goodwill?

The example used above is a very simplified example of a business combination where there is no headroom in the value-in-use calculation leading to an assessment that there is an apparent immediate impairment of the goodwill arising on the business combination. In practice, it is logical that a purchaser might expect to make more profits from the acquisition than the fair value paid for that acquisition.

As a result, and because the value in use calculation is entity-specific, even though the deferred tax is ignored in determining the carrying amount of the CGU there may still be sufficient headroom such that the goodwill is not impaired.

How else can the carrying value of goodwill be justified?

Where it is not possible to justify the carrying value of the goodwill in the ways described above, it may still be possible to avoid an inappropriate impairment charge.

IAS 36.76, which amplifies the requirements of IAS 36.75 referred to above, requires that the carrying amount of a cash-generating unit:

- a) includes the carrying amount of only those assets that can be attributed directly, or allocated on a reasonable and consistent basis, to the cash-generating unit and will generate the future cash inflows used in determining the cash-generating unit's value in use and
- b) does not include the carrying amount of any recognised liability, unless the recoverable amount of the cash-generating unit cannot be determined without consideration of this liability.

This is because fair value less costs to sell and value in use of a cash-generating unit are determined excluding cash flows that relate to assets that are not part of the cash-generating unit and liabilities that have been recognised (see IAS 36.28 and IAS 36.43).

This appears to restrict the inclusion of a deferred tax liability in the calculation of value in use.

However, IAS 36.78 further states (emphasis added):

'It may be necessary to consider some recognised liabilities to determine the recoverable amount of a cash-generating unit. This may occur if the disposal of a cash-generating unit would require the buyer to assume the liability. In this case, the fair value less costs of disposal (or the estimated cash flow from ultimate disposal) of the cash-generating unit is the price to sell the assets of the cash-generating unit and the liability together, less the costs of disposal. To perform a meaningful comparison between the carrying amount of the cash-generating unit and its recoverable amount, the carrying amount of the liability is deducted in determining both the cash-generating unit's value in use and its carrying amount.'

Whilst this paragraph is relevant to the assessment of the fair value less costs to sell, it could be interpreted to allow some flexibility in applying the requirements of the standard when considering which assets and liabilities can be included in the carrying value of a CGU.

It can be argued that, in order to undertake a meaningful impairment calculation, it is necessary to include this deferred tax liability in the net assets of the cash generating unit to which this goodwill relates. However, it would only be appropriate to include this deferred tax liability in the carrying amount of the CGU. Other deferred tax assets and liabilities arising on the business combination must be excluded from the net assets of the CGU in accordance with IAS 36.50.

5.4 Deferred tax and intra-group profits

IAS 12 requires the recognition of deferred tax on all unrealised intra-group profits. Where, for example, a company in the group has sold inventory to another group company and this inventory remains unsold at the year end, the unrealised profit on this intra-group transaction should be eliminated on consolidation. Deferred tax then has to be provided on the difference between the carrying value of that inventory, which will be after elimination of the intra-group profit, and its tax base, which will be the cost of the inventory in the acquiring company, ie before elimination of the intra-group profit.

Where the two group companies pay tax at different rates, the acquiring company's tax rate should be applied to this temporary difference to calculate the deferred tax balance. This is because the tax rate and tax base of the asset must be consistent. The tax base is the deduction that will be available in the future. This will accrue to the acquiring company. Accordingly the applicable tax rate is also that of the acquiring company.

Example 21

Company A purchases inventory for CU10,000 on 30 November 20X1. On 15 December 20X1 Company A sells this inventory to its wholly-owned subsidiary Company B for CU12,500. At 31 December 20X1 the inventory remains unsold by Company B.

Company A pays tax at the rate of 23%. Company B is domiciled in a country where the corporation tax rate is 20%. Company B will record the cost of the inventory as a deduction against future taxable profits. In Company A's separate financial statements, a current tax liability has been recognised related to this sale of inventory to Company B amounting to CU575 (CU2,500 x 23%).

Company A prepares consolidated financial statements in which the inventory is restated to CU10,000, ie the intra-group profit of CU2,500 is eliminated. This stock has an accounting base of CU10,000 and a tax base of CU12,500. There is therefore a deductible temporary difference of CU2,500 (CU12,500 – CU10,000). Therefore, a deferred tax asset of CU500 is recognised (CU2,500 x 20%), subject to there being sufficient future taxable profits against which this deferred tax asset can be recovered.

Section 6: Avoiding pitfalls – share-based payments

Avoiding pitfalls – share-based payments

This section looks at two particular issues that arise in accounting for deferred tax arising on share-based payments, specifically:

- how to calculate the amount to be recognised in equity and the amount to be recognised in profit or loss
- how to account for deferred tax on share based payments not caught by the measurement provisions of IFRS 2 ‘Share-based Payment’.

6.1 Calculating the credit to equity

As set out in Section 2.1, IAS 12 requires a deferred tax asset to be recognised for deductible temporary differences associated with equity-settled share-based payments. In certain jurisdictions, tax law provides for a deduction against corporation tax when share options are exercised. The deduction can be equal to the intrinsic value (market price less exercise price) of the share options at the date they are exercised or computed on another basis specified by the tax law.

As set out in Section 2.1, IAS 12.68C requires any deferred tax credit arising on equity-settled share-based payments to be allocated between profit or loss and equity.

What amount should be credited in profit or loss?

In Example 13 in Section 2.1, the amount of the deferred tax credit to be taken to profit or loss was simply the current year’s share-based payment charge multiplied by the effective tax rate. However, this will not always be the case. Whether any amount should be taken to equity in a given year depends on whether or not there is an ‘excess tax deduction’.

To see whether there is an excess tax deduction, the total expected tax deduction to date should be compared to the cumulative IFRS 2 expense to date. If the expected tax deduction is greater, then there is an excess tax deduction. As noted above, the computation of tax deduction may be different for each jurisdiction and is dictated by the tax law.

For example, in a jurisdiction where deduction for share-based payments is based on the intrinsic value of the share options at the date of exercise, the total expected tax deduction to date is calculated as the number of options expected to be exercised multiplied by their intrinsic value at the reporting date multiplied by the proportion of the vesting period completed. In such a case, the cumulative amount of deferred tax that should be taken to equity is the excess tax deduction multiplied by the effective tax rate. The amount to be taken to equity each period is the difference between this cumulative total and the amounts already recognised directly in equity in previous periods (if any). The amount that should be recognised in profit or loss is then the difference between the total deferred tax credit or debit for the period and the amount taken to equity in that same period.

The number of options expected to be exercised might not necessarily be the same as the number of options expected to vest under IFRS 2.

Example 22

On 1 January 20X1, Company A issues 1,000,000 options. These share options vest three years after the date of grant and have an exercise price of CU2.50. In the country where A is domiciled, corporation tax rate of 23% applies and the tax deduction allowed for share-based payments is the intrinsic value of the share options at the date they are exercised.

Year 1

At 31 December 20X1, the market value of Company A's shares is CU3.25, therefore the share options have an intrinsic value of CU0.75 (CU3.25 – CU2.50). At year end, the company estimates that only 595,000 options will vest and will also be exercised. The share-based payment charge recognised in profit or loss for the year is CU69,417.

The total expected tax deduction to date is CU148,750 (595,000 × 0.75 × 1/3). The cumulative share-based payment charge to date is CU69,417. There is therefore an excess tax deduction of CU79,333 (CU148,750 – CU69,417).

The amount of deferred tax that should be recognised directly in equity is therefore CU18,247 (CU79,333 × 23%), and the amount that should be recognised in profit or loss is CU15,966 ((CU148,750 × 23%) – CU18,247).

The journal to record this deferred tax asset will be:

	Debit CU	Credit CU
Deferred tax asset	34,213	
Deferred tax income (profit or loss)		15,966
Deferred tax income (equity)		18,247

The deferred tax asset of CU34,213 that will be recognised in the statement of financial position is subject to there being sufficient future taxable profits against which this deferred tax asset can be recovered.

Year 2

At 31 December 20X2, the market value of the shares is CU3.50, therefore the share options have an intrinsic value of CU1 (CU3.50 – CU2.50). At year end, the company estimates that 600,000 options will vest and that all of the options that vest will be exercised. The share based payment charge recognised in profit or loss in the year is CU70,583.

The total expected tax deduction to date is CU400,000 (600,000 × 1 × 2/3). The cumulative share based payment charge to date is CU140,000 (CU70,583 + CU69,417). There is therefore an excess tax deduction of CU260,000 (CU400,000 – CU140,000).

The cumulative amount of deferred tax that should be recognised directly in equity is therefore CU59,800 (CU260,000 × 23%). The amount that has previously been recognised directly in equity is CU18,247, therefore the amount that should be recognised directly in equity this year is CU41,553 (CU59,800 – CU18,247).

The deferred tax asset at the end of the previous year was CU34,213. The deferred tax asset that should be recognised at the end of 20X2 is CU92,000 (CU400,000 × 23%), this gives an increase in the deferred tax asset of CU57,787 (CU92,000 – CU34,213). The amount that should be recognised in profit or loss is CU16,234 (CU57,787 – CU41,553).

The journal to record this deferred tax asset will therefore be:

	Debit CU	Credit CU
Deferred tax asset	57,787	
Deferred tax income (profit or loss)		16,234
Deferred tax income (equity)		41,553

Year 3

At 31 December 20X3, the market value of the shares is CU3.15, therefore the share options have an intrinsic value of CU0.65 (CU3.15 – CU2.50). At year end, the company estimates all of the 750,000 options that have vested will be exercised. The share-based payment charge recognised in profit or loss in the year is CU122,500.

The total expected tax deduction to date is CU487,500 (750,000 × 0.65). The cumulative share-based payment charge to date is CU262,500 (CU140,000 + CU122,500). There is therefore an excess tax deduction of CU225,000 (CU487,500 – CU262,500).

The cumulative amount of deferred tax that should be recognised directly in equity is therefore CU51,750 (CU225,000 × 23%). The amount that has previously been recognised directly in equity is CU59,800, therefore the amount that should be recognised in equity is in fact a debit of CU8,050 (CU51,750 – CU59,800), ie a reversal of part of the credit already taken to equity.

The deferred tax asset at the end of the previous year was CU92,000. The deferred tax asset that should be recognised at the end of 20X3 is CU112,125 (CU487,500 × 23%), this gives an increase in the deferred tax asset of CU20,125. The amount that should be recognised in profit or loss is CU28,175 (CU20,125 + CU8,050).

The journal to record this deferred tax asset will therefore be:

	Debit	Credit
	CU	CU
Deferred tax asset	20,125	
Deferred tax income (profit or loss)		28,175
Deferred tax income (equity)	8,050	

6.2 Deferred tax on share options not caught by the measurement provisions of IFRS 2

IFRS 1.D2 'First-time Adoption of International Financial Reporting Standards' provides an exemption from recognising the IFRS 2 expense relating to equity-settled share-based payments granted on or prior to 7 November 2002, or equity-settled share-based payments granted after this date but which vest prior to the later of 1 January 2005 and the date of transition to IFRSs. As set out above, IAS 12.68C requires that where the expected tax deduction exceeds the related cumulative IFRS 2 remuneration expense the tax effect of that excess should be recognised in equity.

Where, in accordance with the transitional provisions of IFRS 1, there is no cumulative remuneration expense, a question arises as to where the deferred tax associated with these equity-settled share-based payments should be recognised. IFRS 1 contains no similar exemption from recognising the deferred tax on options which:

- were granted on or before 7 November 2002 or
- vested before the later of date of transition to IFRSs and 1 January 2005.

As no expense is recognised in profit or loss in relation to these grants then, arguably, the entire deferred tax relating to these grants should be taken direct to equity. This includes both the deferred tax on such grants recognised on transition to IFRSs and subsequent movements in the deferred tax relating to these share-based payments.

Section 7: Avoiding pitfalls – recognition of deferred tax assets

Avoiding pitfalls – recognition of deferred tax assets

The recognition of deferred tax assets is subject to specific requirements in IAS 12. These require a deferred tax asset to be recognised to the extent that it is probable that the deferred tax asset will be recovered. This section covers:

- the recoverability of deferred tax assets where taxable temporary differences are available
- the length of ‘lookout periods’ for assessing the recoverability of deferred tax assets
- the recognition of deferred tax assets in interim financial statements.

7.1 Recoverability of deferred tax assets where taxable temporary differences are available

In assessing whether future taxable profits will be available against which deductible temporary differences, unused tax losses and unused tax credits can be utilised, entities need to take into account various evidence. IAS 12.28 explains that taxable temporary differences relating to the same taxation authority and the same taxable entity as the deductible temporary differences are one source of evidence that taxable profits will be available.

If these compatible taxable temporary differences will reverse in the same periods as the deductible temporary differences or in periods into which tax losses may be carried back or forward, deferred tax assets should be recognised (IAS 12.28 and 36). In other words, deferred tax assets should be recognised, at a minimum, to the extent of existing taxable temporary differences that are likely to negate the effects of any deductible temporary differences, unused tax losses or unused tax credits.

Example 23

Example 23a – deductible and taxable temporary difference relate to the same taxable entity

In a business combination, an intangible asset is recognised relating to the acquired entity’s trade operations. This intangible asset has a carrying amount of CU2 million at the date of the combination. Under the applicable tax rules, the carrying amount of the asset is not tax-deductible and there is also no tax deduction available on the sale of the asset. The tax base of this intangible asset therefore is nil and no other temporary difference exists.

The acquired business has accumulated unused tax losses of CU5 million that can be deducted from any future taxable profit. The unused tax losses are not subject to any expiry date or limited to a certain type of taxable income. The acquired business, however, is not expected to become profitable in the foreseeable future. Therefore the entity needs to record two deferred tax items:

- a deferred tax liability based on the taxable temporary difference of CU2 million on the intangible asset
- a deferred tax asset for its unused tax losses. As the acquired entity is not likely to become profitable in the foreseeable future, deferred taxes based on its unused tax losses should only be recognised to the extent of taxable temporary differences that arise upon the recognition of the intangible asset, ie CU2 million.

Upon their initial recognition in the course of the business combination, both deferred tax items should be included in the calculation of goodwill or excess of the acquirer’s interest in the acquiree’s net assets over the cost of the combination (IAS 12.66).

Example 23b – deductible and taxable temporary difference relate to different components of performance

An entity records an available-for-sale financial asset (AFS asset) at an initial cost of CU1 million, which is equal to its tax base. At the reporting date, the fair value of the AFS asset is CU1.3 million, thus resulting in a pre-tax gain of CU300,000, which is recognised in other comprehensive income (IAS 39.55(b)). The tax base of this asset is not affected by the rise in its fair value.

The entity also has accumulated unused tax losses of CU8 million that can be deducted from any future taxable profit and are not subject to any expiry date or limited to a certain type of taxable income. Again, the entity is not expected to generate taxable profits in the foreseeable future. Based on these circumstances, the entity needs to record two deferred tax items:

- a deferred tax liability based on the taxable temporary difference of CU300,000 on the gain arising on the revaluation of the AFS asset, as the tax base is not affected by its new carrying amount
- a deferred tax asset for its unused tax losses. As the entity does not expect taxable profits in the foreseeable future, a deferred tax asset for unused tax losses should only be recognised to the extent of existing taxable temporary differences, ie CU300,000.

The deferred tax liability arising on the revaluation of the AFS asset is recognised in other comprehensive income, as the underlying transaction is also recognised in other comprehensive income (IAS 12.58(a)). However, the deferred tax asset relates to unused losses and so gives rise to a deferred tax income in profit or loss, because it does not relate to a business combination or a transaction that is recognised in other comprehensive income or equity.

7.2 Lookout periods for future taxable profits

Deferred tax assets arising from available tax losses are recognised if the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available (IAS 12.35). Entities may therefore look forward for a number of future accounting periods to determine whether they will have sufficient taxable profit to justify recognising a deferred tax asset.

In these circumstances, there is no specific restriction on how many years the entity may look forward ('the lookout period'), unless there is a date at which the availability of the tax losses expires. The uncertainties of the future mean that the evidence supporting future profits in later periods will generally not be as convincing as that for earlier periods, but there is no rule as to the duration of the lookout period. This depends on the facts and circumstances of the particular situation in question.

The unavailability of detailed profit forecasts is not necessarily a bar to assuming that profits for later years are available to support a deferred tax asset. If there are detailed forecasts showing profits for the next three years, it may be unlikely that profits would reduce to nil in year four. The key issue is that the profits are probable and that there is convincing evidence to support management's assumptions.

An entity's projections should be, generally, consistent with the assumptions made about projection periods in other areas of financial reporting. For example, assumptions used in value in use impairment testing calculations would be expected to be consistent with assumptions used in determining whether a deferred tax asset is recoverable.

7.3 Recognition of deferred tax assets in interim financial statements

The recoverability of deferred taxes should be re-assessed at the end of each reporting period using the criteria set out in IAS 12.36. If the re-assessment results in an increase or decrease of the amount recognised for deferred tax, the change is recorded in profit or loss unless it relates to another component of the financial statements as discussed in Section 2. Most changes in the carrying amount of recognised deferred tax assets therefore affect the average effective tax rate of an entity, ie income tax expense or income divided by the accounting profit, as defined by IAS 12.86. This includes both deferred taxes and current taxes.

IAS 34 'Interim Financial Reporting' requires an entity to apply the same accounting policies in its interim financial statements that it applies in its annual financial statements (IAS 34.28).

The above basic principle suggests that deferred tax assets should therefore be tested for recoverability and adjusted as necessary at the end of the interim reporting period. So, for example, if an entity determines at the end of an interim reporting period that a previously unrecognised deferred tax asset will be recoverable in full, it seems that it should recognise an asset in the interim statement of financial position. However, the corresponding entry in profit or loss will give rise to an increase or decrease in the effective income tax rate for that interim financial period.

This seemingly contradicts the specific measurement principle for income tax expense in interim financial statements, which requires that income tax expense should be recognised 'in each interim period based on the best estimate of the weighted average annual income tax rate expected for the full financial year...' (IAS 34.30(c)). Interim income tax expense therefore is calculated by applying to an interim period's pre-tax income, the tax rate that would be applicable to expected total annual earnings, that is, the estimated average annual effective income tax rate. This concept is further explained in IAS 34 Appendix B paragraphs B12 to B16. IAS 34.B13 explains that this is consistent with the requirement of IAS 34.28 because income taxes are assessed on an annual basis so an annualised approach is needed in interim accounts.

Therefore, a two-step approach may be required for deferred tax assets in interim periods:

- a) Firstly, whether or not a deferred tax asset can be recognised is assessed at the interim date using IAS 12.36
- b) Secondly, the calculation of the amount to be recognised in the interim accounts is then determined using a combination of the amount expected to be recognised as recoverable at the end of the full financial year and the estimated annual effective income tax rate in accordance with IAS 34.30(c).

IAS 34.B20 to B22 deal with a case where the probability of future taxable profits is reassessed in the first interim period such that a previously unrecognised deferred tax asset is considered recoverable within the current full accounting year. In this case, the deferred tax asset is not recognised at the end of the interim period but is instead recognised within the calculation of the tax expense for the period as follows:

Example 24

Company A reports quarterly and has operating losses to carry forward of CU10,000 for income tax purposes at the start of the current financial year for which a deferred tax asset has not been recognised. Company A earns CU10,000 taxable profits in the first quarter of the current year and expects to earn CU10,000 in each of the three remaining quarters. Excluding the carry forward, the estimated average income tax rate is expected to be 40%.

The taxable income for the current year is therefore expected to be CU30,000 (CU10,000 × 4 – CU10,000 loss carried forward) and the tax payable will be CU12,000 (CU30,000 × 40%). This gives an effective annual tax rate of 30% (CU12,000 ÷ 40,000).

The tax expense for each interim period is calculated as 30% of actual earnings in the period, as follows:

	Quarter 1	Quarter 2	Quarter 3	Quarter 4	Quarter 5
	CU	CU	CU	CU	CU
Tax expense	3,000	3,000	3,000	3,000	12,000

Where the probability of future taxable profits is such that the whole of the deferred tax asset is not considered recoverable in the current year, a deferred tax asset will be recognised in the statement of financial position at the end of the financial year, assuming that future taxable profits are expected against which it can be recovered. The estimated deferred tax asset to be recognised at the end of the year should be built into the calculation of the estimated annual effective income tax rate.

An example of how this can be achieved is demonstrated below:

Example 25

Company A reports quarterly and operates in a tax jurisdiction with a 40% tax rate. Company A has operating losses to carry forward of CU40,000 for income tax purposes at the start of the current financial year, which can be offset against profits for the current and the next financial year only. At the start of the year, the Company estimates that CU16,000 of the losses can be recovered against profits for the current year and the remaining CU24,000 recovered against profits for the next financial year. A deferred tax asset has been recognised in the opening statement of financial position of CU16,000 (CU40,000 × 40%). The Company earns CU4,000 taxable profits in the first quarter of the current year and expectations for the remainder of the year are in line with budget. However, the budgeted profit for the following year has been reduced to CU20,000. Consequently, the deferred tax asset to be recognised at the end of the current year should be reduced by CU1,600 ((CU24,000 – CU20,000) × 40%).

Therefore, the estimated effective annual tax rate is: [(CU16,000 × 40%) + CU1,600] ÷ CU16,000 = 50%.

Assuming profit is earned straight-line through the year, the tax expense for each interim period is calculated as 50% of actual earnings in the period, as follows:

	Quarter 1 CU	Quarter 2 CU	Quarter 3 CU	Quarter 4 CU	Quarter 5 CU
Tax expense	2,000	2,000	2,000	2,000	8,000

Accounting for the derecognition of a deferred tax asset in an interim period

It is less clear what the appropriate accounting treatment is at the end of an interim period where management concludes that a previously recognised deferred tax asset is no longer recoverable. There would appear to be two acceptable accounting treatments. Either:

- write off the entire deferred tax asset at the interim reporting date as it is no longer considered recoverable or
- spread the effect of the write off over the interim and final accounts period through the computation of an estimated annual effective tax rate. This method is consistent with the IAS 34.B20 to B22 approach discussed above.

Management should select one of these alternatives as an accounting policy and apply it consistently in interim reports.

Section 8: Avoiding pitfalls – other issues

Avoiding pitfalls – other issues

This section is a summary of other issues which can arise in practice, namely:

- whether a particular taxation regime meets the definition of an income tax
- the tracking of temporary differences arising on initial recognition
- the accounting for changes in an asset's tax base due to revaluation or indexation of that tax base
- the treatment of deferred tax on gains and losses relating to an available-for-sale financial asset reclassified to profit or loss
- accounting for deferred tax on compound financial instruments
- reflecting uncertainty over whether specific tax positions will be sustained under challenge from the relevant tax authorities.

8.1 Definition of an income tax

The scope of IAS 12 is limited to income taxes.

This is defined in IAS 12.2 as follows:

'For the purposes of this Standard, income taxes include all domestic and foreign taxes which are based on taxable profits. Income taxes also include taxes, such as withholding taxes, which are payable by a subsidiary, associate or joint arrangement on distributions to the reporting entity.'

As a result, if taxes are not based on 'taxable profits', they are not within the scope of IAS 12. For example, sales or payroll taxes are not income taxes. These taxes are based on the sales an entity generates or on salaries and wages it pays to its employees.

However, with some other types of tax the question of whether the definition of an income tax is met is less clear. For example, when an entity is not taxed on the basis of its accounting profit, the assessment basis of taxation may still be considered taxable profit. The IFRIC has acknowledged that whether a tax is within or outside the scope of IAS 12 is an area of interpretation and has pointed out in one of its agenda rejection decisions that '...the term 'taxable profit' implies a notion of a net rather than gross amount'.

Therefore, if a tax is based on a net income figure, (ie revenues less deductions) it will generally meet the definition of an income tax and needs to be considered in accounting for current and deferred tax under IAS 12. On the other hand, taxes levied on gross amounts (such as revenues or assets) are generally outside the scope of IAS 12.

Some taxes are assessed on different bases depending on the circumstances. For example, to secure a stable flow of tax payments to the tax authorities or for simplification, taxes may be based not only on taxable profits, but also on another amount such as sales or capital employed. An analysis of whether the tax is an income tax might focus on the assessment basis that is most likely to apply to the entity in practice. Moreover, where a tax may be imputed on an assessment basis that is a substitute for a net income figure, it could be regarded as an income tax within the scope of IAS 12.

One tax commonly substituted for corporation tax is the tonnage tax regime, typically used in the shipping industry in many tax jurisdictions. Whether this falls within the definition of an income tax has been a matter of some debate. In its May 2009 meeting, the IFRIC concluded that tonnage tax was not within the scope of IAS 12 because it is based on gross tonnage and not on net profit.

8.2 Accounting for initial temporary differences after day one

Where initial recognition differences have been identified that are subject to the exemptions set out in IAS 12.15(b) and 24, no deferred taxes are recognised at initial recognition of the asset or liability. Further, subsequent changes in the unrecognised deferred tax assets or liabilities are also not recognised (IAS 12.22(c)). The entity therefore needs to identify exempt initial temporary differences and distinguish them from subsequent temporary differences, which are not subject to the initial recognition exemption.

Changes in temporary differences result from changes in either the carrying amount or the tax base of an asset or liability. IAS 12 does not, however, explain comprehensively how to distinguish changes in temporary differences that relate to initial recognition from subsequent temporary differences.

Subsequent to initial recognition, assets and liabilities may be measured in the financial statements at fair values. The resulting changes in the carrying amount affect the asset's or liability's temporary difference. The tax base of an asset or a liability may, alternatively, be subject to an indexation allowance scheme or a revaluation for tax purposes that gives rise to future tax deductions. Both situations raise the question whether the initial recognition difference has been affected or if a subsequent temporary difference has been established.

There are many reasons for subsequent changes in temporary differences. Each needs to be assessed drawing on the guidance in IAS 12. The tax base may also be changed by many different factors. This is therefore an area of interpretation.

One approach to arrive at a consistent accounting policy is to assess whether the change in the temporary difference results from (i) the 'consumption', or use, of the original carrying amount and/or tax base, or (ii) from the revaluation of the asset, liability or tax base. For example, the following may be regarded as a consumption of the original amounts which change pre-existing exempt initial recognition differences:

- the impairment or the reversal of a previous impairment of the original carrying amount
- the depreciation or amortisation of an asset's or liability's original carrying amount and/or
- the change of the tax base caused by taking tax deductions.

These changes should not affect accounting for deferred taxes. These differences relate to initial recognition and remain exempted in accordance with IAS 12.15(b) or 24.

However, when the asset or liability is revalued, any change between the previous carrying amount and the revalued carrying amount should be considered as a new temporary difference. The initial recognition exemption does not then apply. Deferred tax will or may need to be recognised.

The same principle applies to the corresponding tax base. If future tax deductions are restated or revalued, eg as a result of an indexation allowance scheme, this also establishes a subsequent temporary difference, which, therefore, should be included in accounting for deferred taxes.

Example 26

On 31 December 20X1, entity A acquires a building for CU1 million. The cost of the building will never be deductible for tax purposes in the country where entity A is domiciled, even upon its eventual disposal. Therefore, the tax base is nil and a taxable temporary difference of CU1 million arises, for which the initial recognition exemption applies. Hence, no deferred tax liability is recognised in accordance with IAS 12.15(b).

The building is subsequently measured using IAS 16's revaluation model. It is recorded at its fair value at the date of the revaluation less any subsequent accumulated depreciation and impairment losses in accordance with IAS 16.31. In the years to 31 December 20X2 and 31 December 20X3, the entity depreciates the building over its useful life, considered to be 20 years, so that at the end of the periods, the carrying amount of the building is CU950,000 and CU900,000, respectively. In addition, the building is revalued to its current fair value of CU1.2 million at 31 December 20X3, with a corresponding pre-tax gain of CU300,000 (CU1.2 million – CU900,000) recorded in other comprehensive income.

The subsequent depreciation of the asset in the years to 31 December 20X2 and 31 December 20X3 could be considered to be a change of the original carrying amount of the building and thus should be considered to be a consumption of the initial temporary difference. The depreciation-related change of the initial temporary difference of CU1 million should therefore not be included in accounting for deferred taxes. The revaluation of the asset, however, does not relate to the initial temporary difference at all and therefore gives rise to a subsequent temporary difference of CU300,000, in respect of which deferred tax is recognised. The deferred tax should be recognised in other comprehensive income as this is where the revaluation gain has been recognised.

In the year to 31 December 20X4 the building is not revalued. The revalued carrying amount of CU1.2 million will be depreciated over its remaining useful life of 18 years. The carrying value of the building is therefore CU1.13 million (CU1.2 million – (CU1.2 million/18 years)). The tax base is still nil and therefore the temporary difference is CU1.13 million. However, the initial temporary difference of CU1 million, on which no deferred tax is calculated, is now “amortised” to CU850,000 (CU1 million x 17/20years). Therefore deferred tax is provided on CU280,000 (CU1.13 million – CU850,000).

8.3 Changes in an asset's tax base due to a revaluation or indexation

IAS 12.65 explains that an entity must look at the way an asset is measured subsequently when it determines whether the deferred tax effect of a revaluation of the asset for tax purposes should be recognised in other comprehensive income or profit or loss. The deferred tax effect of a revaluation of an asset for tax purposes should only be recognised in other comprehensive income if the revaluation for tax purposes relates to a recent or future revaluation of the asset under IFRSs, which will be or has been recognised in other comprehensive income.

Hence, where an asset is not revalued under IFRSs, and so there are no adjustments to its carrying amount charged or credited in other comprehensive income, any resulting deferred tax asset or liability from a tax revaluation will give rise to a corresponding income or expense to be included in profit or loss.

IAS 12 does not take into consideration other changes in an asset's tax base. In fact, the standard does not even define what constitutes a revaluation for tax purposes. Arguably, IAS 12.65 should also be applied to circumstances where the tax base of an asset is subject to an indexation allowance. The principle again is that the deferred tax effect is charged to other comprehensive income if and only if the indexation is ‘related’ to an accounting revaluation. In most cases, they will be based on different valuation metrics and hence this will not be so.

8.4 Gains and losses relating to an available-for-sale financial asset reclassified to profit or loss

When an available-for-sale financial asset is derecognised, the corresponding cumulative gain or loss previously recognised in other comprehensive income needs to be reclassified to profit or loss (IAS 39.55(b)). IAS 12 is silent on the allocation of deferred tax income or expenses that previously have been charged or credited directly to other comprehensive income.

As the financial asset is derecognised, the corresponding temporary difference ceases to exist. The associated deferred tax asset or liability therefore has to be eliminated. The release of the deferred tax asset or liability should be recognised through other comprehensive income. This is because the deferred tax effect of the cumulative gain or loss was previously recognised in other comprehensive income.

8.5 Deferred tax on compound financial instruments

IAS 12 takes the view that a temporary difference arising from separation of a compound financial instrument into its liability and equity component does not relate to initial recognition (IAS 12.23). Consequently, any temporary difference arising is not excluded by the initial recognition exemption and deferred tax must be recognised where applicable.

IAS 12.23 also specifies that:

- a) the initial deferred tax on a taxable temporary difference resulting from separation of a compound instrument is charged to equity, following the principle in IAS 12.61A that deferred tax is recorded in equity if it relates to an item charged or credited directly to equity in the same or a different period, and
- b) subsequent changes to this deferred tax liability are recorded in profit or loss, in accordance with IAS 12.58.

The temporary difference is the difference between the carrying amount of the liability component and its tax base. The liability component is determined in accordance with IAS 32 'Financial Instruments: Presentation'.

The tax base of the liability should be determined based on the general definition in IAS 12.8. This can be expressed as the following formula:

$$\text{Tax base (of a liability)} = \text{carrying amount} - \text{future deductible amounts} + \text{future taxable amounts}$$

In many jurisdictions, the initial tax base of a compound instrument is equal to the total proceeds of the instrument, ie the instrument is treated as 'straight' debt for tax purposes with no separation into debt and equity.

For example, consider an entity that issues a convertible bond for total proceeds of CU1 million, of which CU900,000 is determined to be a liability component and CU100,000 the equity component. The entity will record a liability of CU900,000 on the issue date. Assume that if the issuer settled the instrument on the same day for CU900,000, a taxable gain of CU100,000 would arise under the relevant tax laws. In that scenario the tax base is CU1 million.

This is confirmed by applying the following formula for determination of tax bases:

$$\text{Tax base (of a liability)} = \text{carrying amount} - \text{future deductible amounts} + \text{future taxable amounts}$$

$$\text{Tax base} = \text{CU900,000} - \text{nil} + \text{CU100,000} = \text{CU1 million}$$

Tax treatment affected by manner of settlement

In some jurisdictions, the tax treatment of a compound instrument might depend on whether it is converted or redeemed. For example, notional interest expense included in the liability component, as a result of measurement at amortised cost using the effective interest method, might be deductible for tax purposes only if the bond is redeemed. In accordance with IAS 12.51-51E, measurement of deferred tax should reflect the expected manner of settlement. The manner of settlement might affect the tax base, the tax rate, both or neither.

When a deductible temporary difference arises if the bond is settled in the expected manner, additional analysis is required to determine whether the resulting deferred tax asset qualifies for recognition. A deferred tax asset should be recorded only when it is probable that the entity will have sufficient taxable profits against which the deductible temporary difference may be utilised.

Example 27 – convertible bond with tax base not affected by manner of settlement

Company A issues a convertible bond for CU800 on 1 January 20X1. No interest will be paid. The bondholders can convert each bond into a fixed number of equity shares of Company A on 31 December 20X5. The bond must be redeemed, if not converted, for CU800 on 31 December 20X5.

On 1 January 20X1, Company A determines that the market interest rate for a similar bond with no conversion option is 2.71%. On this basis, the liability component of the bond is determined to be CU700. The liability is to be measured at amortised cost using the effective interest rate.

Under the relevant jurisdictional tax laws, the bond is regarded as a loan of CU800. The imputed interest charges are not tax deductible. Conversion of the bond has no additional tax consequences. The applicable tax rate is 23%.

The tax base of the bond is CU800. A taxable temporary difference of CU100 therefore arises on initial recognition. A deferred tax liability of CU23 (CU100 × 23%) is recorded on 1 January 20X1. In accordance with IAS 12.23, the corresponding charge is recorded in equity.

The respective entries on 1 January 20X1 are as follows:

	Debit CU	Credit CU
Cash	800	
Equity – conversion option		100
Financial liability		700
Deferred tax liability		23
Equity – deferred tax	23	

The subsequent accounting entries for 20X1 to 20X5 are summarised below:

	20X1 CU	20X2 CU	20X3 CU	20X4 CU	20X5 CU
Carrying amount of liability – opening	700	719	738	758	779
Imputed interest expense	19	19	20	21	21
Carrying amount of liability – closing	719	738	758	779	800
Tax base	800	800	800	800	800
Taxable temporary difference – opening	100	81	62	42	21
Taxable temporary difference – closing	81	62	42	21	0
Deferred tax liability at 23% – opening	23.0	18.6	14.2	9.6	4.8
Credited to profit or loss	(4.4)	(4.4)	(4.6)	(4.8)	(4.8)
Deferred tax liability at 23% – closing	18.6	14.2	9.6	4.8	0

Example 28 – convertible bond with tax base dependent on manner of settlement

Company A issues a bond on 1 January 20X1 on exactly the same terms as the previous example. The market interest rate is also the same. However, in this case the relevant tax laws differ such that:

- the tax treatment of the bond follows the accounting. Accordingly the tax authorities treat the bond as a debt issuance of CU700 and a written warrant of CU100 and
- the interest accrued will be deductible if the bond is redeemed but not if converted.

In this case, there is no temporary difference on initial recognition. Consequently, no deferred tax is recorded on 1 January 20X1.

Subsequently, Company A records interest on the liability component. The accrued interest creates a deductible temporary difference because it represents a future deduction that would arise if the liability were settled for its carrying amount. For example, at 31 December 20X4 the carrying amount of the liability is CU779, see table above. The tax base is CU700 on redemption, but CU779 on conversion. The tax base formula confirms this as follows:

Tax base (of a liability) = carrying amount – future deductible amounts + future taxable amounts

Tax base (redemption) = CU779 – CU79 + nil

Tax base (conversion) = CU779 – nil + nil

Accordingly a deductible temporary difference of CU79 exists at this date if Company A expects to settle the bond by redemption. A deferred tax asset of CU18 (CU79 × 23%) is recorded, to the extent that it is probable that Company A will have sufficient taxable profits against which this deductible temporary difference may be utilised. However, if Company A expects the bond to be settled by conversion into shares there is no temporary difference so no deferred tax is recognised.

8.6 Reflecting uncertain tax positions

Entities generally seek to reduce their income taxes payable, aiming to pay the minimum due under the relevant tax laws. This might include organising aspects of their business and structuring certain transactions to achieve a more favourable tax treatment. However, due to the complexities of many business transactions and the uncertainties inherent in tax laws, entities frequently face uncertainty as to the tax consequences of some transactions and arrangements (uncertain tax positions). For example, it might be uncertain as to whether items of income are taxable or expenses are deductible. Frequently such uncertain tax positions reflect the potential for differing interpretations of tax laws when applied to specific transactions and arrangements. This could have a consequential impact on an entity's deferred tax calculations.

IAS 12.5 defines taxable profit (or tax loss) in terms of the rules established by the taxation authorities. One consequence of this definition is that entities need to make a best estimate of the taxes payable or recoverable, on the basis that the relevant tax rules will be enforced. It is not therefore appropriate to reduce the amount of taxes payable on the grounds that the authorities might overlook or decide not to investigate or challenge a tax position (sometimes described as detection risk). In effect, the entity should assume that its tax positions will be detected and challenged, and make its estimates on the basis of the expected outcome of the challenge.

A best estimate approach involves making a judgement as to which interpretation of the relevant tax laws is most likely to be sustained in an entity's particular circumstances. Taxes payable are then estimated according to that interpretation. In some situations tax authorities might notify the entity or market of their interpretation of certain tax laws. The entity might intend to challenge that position but the tax authority's view is likely to indicate the most likely outcome until it is successfully challenged. Specialist tax or legal advice may be needed to determine the best estimate.

The best estimate of the taxes payable should be revised, as facts and circumstances change. The uncertainty will be removed once taxes payable have been substantially agreed by the relevant authority. Before that, the steps and procedures for the final determination of taxes payable might provide additional evidence that makes it appropriate to revise the estimate. Typically, those steps include:

- filing a tax return
- the tax authority either accepting or querying the return
- tax audit or investigation and
- legal or other proceedings for the resolution of disputed positions.

Income taxes are not within the scope of IAS 37 'Provisions, Contingent Liabilities and Contingent Assets' (IAS 37.5(b)). Accordingly, income tax-related liabilities (or contingent liabilities) are not subject to a probability recognition threshold. However, fines and penalties levied by tax authorities (eg late-filing penalties) are not income taxes as defined in IAS 12 and, therefore, should be recognised and measured in accordance with IAS 37.

Example 29

An entity is preparing its 20X0 financial statements. At the start of the year the entity purchased an asset which is being used in the entity's research and development activities. It is uncertain whether the asset will qualify for a research and development accelerated wear and tear tax allowance. The allowance permits qualifying assets to be written off in full in the year of purchase. The entity's professional advisors estimate that there is a 60% chance that the asset would not qualify for the allowance under challenge. However, it is also estimated that the authority scrutinises only 50% of returns. If the asset does qualify for the allowance the entity's 20X0 deferred tax liability is CU2,000. This decreases to CU1,000 if the asset does not qualify.

In 20X1 (after the 20X0 financial statements have been approved) the entity files its 20X0 tax return. The return shows the asset as qualifying for the special allowance with full disclosure of its nature. During 20X1 the tax authority agrees the return without challenge.

In its 20X0 financial statements the entity makes an estimate of its deferred tax liability based on its assessment of the most likely effect of the relevant tax laws. The entity's expectation is that, if challenged, the asset is more likely than not to fail to qualify for the special allowance. The deferred tax liability is therefore computed on the basis that the asset does not qualify. This would result in a deferred tax liability of CU1,000. No adjustment is applied for the possibility that the tax return will not be scrutinised.

In 20X1, the tax return is agreed without challenge. Since the entity has disclosed the uncertainty and has not been challenged, the deferred tax liability for 20X0 is substantially agreed at an amount of CU2,000. Accordingly, the 20X1 deferred tax calculation is updated and prepared on the basis that the asset did qualify for the allowance in 20X1.

Appendix A: Glossary

The following definitions are drawn from the definitions in IAS 12:

Term	Description
Accounting profit	Accounting profit is the profit or loss for a period before deducting tax expense.
Current tax	Current tax is the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period.
Deductible temporary difference	Deductible temporary differences are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.
Deferred tax liabilities	Deferred tax liabilities are the amounts of income taxes payable in future periods in respect of taxable temporary differences.
Deferred tax assets	Deferred tax assets are the amounts of income taxes recoverable in future periods in respect of: <ul style="list-style-type: none">• deductible temporary differences• the carryforward of unused tax losses and• the carryforward of unused tax credits.
Tax base	The tax base of an asset or liability is the amount attributed to that asset or liability for tax purposes.
Tax base of an asset	The tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset. If those economic benefits will not be taxable, the tax base of the asset is equal to its carrying amount.
Tax base of a liability	The tax base of a liability is its carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods. In the case of revenue which is received in advance, the tax base of the resulting liability is its carrying amount, less any amount of the revenue that will not be taxable in future periods.
Tax expense (tax income)	Tax expense (tax income) is the aggregate amount included in the determination of profit or loss for the period in respect of current and deferred tax.
Taxable profit (tax loss)	Taxable profit (tax loss) is the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable).
Taxable temporary differences	Taxable temporary differences are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.
Temporary difference	A temporary difference is a difference between the carrying amount of an asset or liability in the statement of financial position and its tax base. Temporary differences may be either taxable temporary differences or deductible temporary differences.

IAS 12 does not define an income tax but the following description is contained in IAS 12.2:

‘For the purposes of this Standard, income taxes include all domestic and foreign taxes which are based on taxable profits. Income taxes also include taxes, such as withholding taxes, which are payable by a subsidiary, associate or joint arrangement on distributions to the reporting entity’.



www.gti.org

© 2013 Grant Thornton International Ltd. All rights reserved. Grant Thornton International Ltd and the member firms are not a worldwide partnership. Services are delivered independently by the member firms.

Grant Thornton International Ltd is a company limited by guarantee incorporated in England and Wales.
Registered number: 05523714
Registered office: Grant Thornton House, 22 Melton Street, Euston Square, London NW1 2EP