Mind the GAPs in IAS12 Deferred Taxation

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Introduction

The guidance for reporting taxation in financial statements is addressed in IAS12 *Income Taxes.* IAS12 was issued in October 1996. Since it was first published it has been the subject of much review, comment and revision. In 2019 alone, there was further development in this area with the publication of three separate statements on this area: IFRIC23 *Uncertainty over Income Tax Treatments,* ED *deferred tax related to assets and liabilities arising from a single transaction* and finally ESMA's (European Securities and Markets Authority) Public Statement *Considerations on recognition of deferred tax assets arising from the carry forward of unused tax losses*.

Deferred tax liabilities are commonly found in capital intensive industries such as electricity, utility, manufacturing and others where fixed assets are depreciated at a higher rate for tax purposes than for accounting purposes.

This note provides a summary of the existing rules of IAS12 in relation to deferred taxation.

Background

So let us begin with a recap of the current rules. IAS12 is divided into two main guidance areas these being Current Taxation and Deferred Taxation. Current Tax is the income tax payable (or recoverable) in respect of the taxable profit (or loss) for a period while deferred taxation relates to the future tax consequences of current transactions and events. This teaching note concentrates on deferred taxation. The principal rule of IAS12 deferred taxation is that an entity accounts for the tax consequences of transactions and other events in the same way and in the same accounting period that it accounts for the transactions and other events themselves.

Before we get into the technicalities of IAS12 it is worth noting three important points for students. First of all IAS12 *is* a difficult accounting standard. It requires a different way of thinking. The terminology can be overwhelming and difficult to understand. It is a subjective accounting standard and one is never quite sure if one is on solid ground when applying the provisions. There has always been unease with this accounting standard and this applies to both students and practitioners. In fact, one of the most recent IASB pronouncements in this area IFRIC23 addresses the issue of uncertainty in relation to deferred taxation. It is acknowledged that entities do not always know how their tax authority may view a particular treatment applied in their tax returns. IFRIC23 states that '*where it is considered not probable that the tax authority will accept the tax treatment used or planned to be used, the effect of uncertainty should be estimated using either the most likely amount or the expected value method, depending on which method better predicts the resolution of the uncertainty*.' So rest assured if you are feeling unsure, you are not alone.

Secondly, this teaching note is written with Advanced Corporate Reporting (ACR) students in mind, not taxation practitioners. A recent Deloitte finding on taxation suggests that the responsibility for tax accounting often falls into the gap between the tax practitioner and the tax accountant. Nobody quite wants it but it has to be done. With this general aversion in mind and the subjectivity of the issue (and to offer you a little guidance) it is only fair to point out that if deferred taxation is to be examined in ACR, that it will be clearly specified in the examination requirements *and* the relevant taxation rules will be outlined where necessary. This might give you a little comfort when approaching your studies.

Finally, one of the major issues I have found in teaching deferred tax is the wording of the standard. It can be hard enough to grasp the concepts of IAS12 but this is made even more difficult by the way the Standard is written. The problem is that IAS 12 is balance sheet driven (also known as the valuation approach). The standard therefore focuses on the cumulative position. Although this general approach is consistent with the *Conceptual framework*, which focuses on the financial position rather than the income statement, it does not help the learner to grasp what is already a challenging issue. What this means for preparing deferred tax calculations for an accounting period is that one needs to think in layers. Begin with identifying the cumulative temporary differences at the end of the financial period as identified from the closing statement of financial position, deduct the cumulative temporary differences that were there at the start of the year (from the opening statement of financial position) and this will give you the changes during the financial period.

Deferred Taxation – three sections

For the purpose of this teaching note I have broken IAS12 into three separate sections:

1. Deferred tax liabilities/assets arising from single entity transactions and events.
2. Additional entries for Groups.
3. Deferred tax assets/liabilities arising from other transactions and events

1. Deferred tax liabilities/assets arising from single entity transactions and events.

Deferred taxation occurs when the tax rules of a jurisdiction result in the tax effect of an accounting transaction occurring in a different period to the transaction itself. We have already stated that the principal rule of IAS12 is that an entity accounts for the tax consequences of transactions and other events in the same way (and in the same accounting period) that it accounts for the transactions themselves. In other words the financial statements will include the tax effects of all of its transactions and events whether or not the taxation has actually been levied on them. Where taxation is charged in the accounts but has not yet been levied by the tax authorities then a gap arises. Deferred taxation bridges this gap.

Deferred tax fills the gap (or almost fills the gap) between actual tax charge for a period based on tax laws and the tax expense based on the financial accounts. In this way, deferred tax fulfils the matching principle as determined by the Conceptual Framework.

Take the following simple example:

X plc reports accounting profits of €100,000 for the year ended 31.12.19. Taxation is 10% per annum. The tax charge as levied by the Tax Authority for the same period is €9,000.	
Tax charge based on accounting profits (€100k*10%)	€10,000
Tax charge based on taxable profits	€9,000
Difference to bring tax charge in line with accounting profits	€1,000

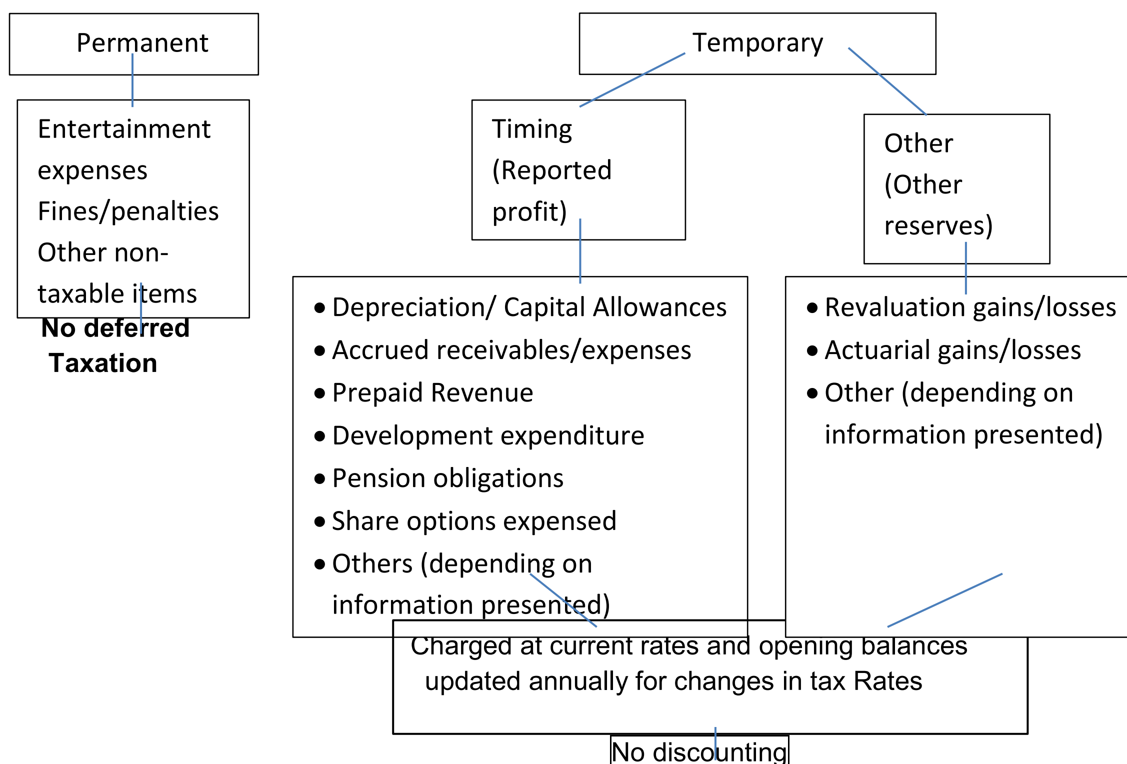
The Journals for this include:

- Db Tax Expense €9,000
  Cr Bank/Tax Liability €9,000
  With the current tax expenses
- Db Tax Expense €1,000
  Cr Deferred tax Liability €1,000

With the additional tax charge to bring the tax expense in line with the accounting profits

Classification of differences between financial statements and taxation levied by the tax authority.

So, let us turn our attention to what types of transactions lead to these differences. IAS12 classifies these differences into a number of different groups:



(i) *Permanent and Temporary Differences:*

The majority of differences between the accounting profits and taxable profits are temporary in nature. This means that transactions and events may appear in the financial accounts in one period but are taxed in a different period. Deferred taxation is calculated on those temporary differences in the year that the accounting transaction arises (and reversed in the year the tax is actually levied). However, other transactions and events give rise to permanent differences –that is they are included in the financial statements but will never give rise to a tax effect. No deferred tax is provided on permanent differences as differences are permanent. They will never reverse. We say therefore that deferred taxation *almost* bridges the taxation gap.

(ii) *Timing and Other*

Temporary 'timing' differences are those temporary differences that affect the reported profit figure. Any deferred taxation arising from timing differences are included in the reported tax expense in the profit and loss account for the period. Temporary 'Other' differences are those temporary differences that arise on entries that were posted to accounts other than to profit figure for the period. For example, revaluation gains/losses by-pass the reported profit and are posted directly to reserves. Any deferred tax arising will be posted to that same reserve.

Temporary differences (either timing or other) that give rise to additional tax charges are classified as <u>Temporary Taxable differences</u> while differences that give rise to a deduction in tax charges are called <u>Temporary Deductible differences.</u>

Examples

Item (examples)	**Account Base**	**Tax Base**	**This means**	**This is Known as**	**Accounting**
PPE	Book Depreciation and (NBV)	Capital Allowance and (TWV)	If capital allowances> depreciation then TWV is lower than NBV AND therefore accounting profits are > taxable profit Must provide for deferred tax to bring tax expense **up to** level of tax on accounting profit	Taxable Timing difference	Provide Deferred tax liability
Deferred Revenue	Revenue is included in liabilities and not in profit	Revenue included for tax	Accounting profits are < taxable profits Must provide for deferred tax relief to bring tax **down to** level based on accounting profits	Deductibe Timing difference	Provide Deferred tax asset
Revaluation surplus on non current asset	Gain recognised for accounting purposes	Gain is taxed only on disposal of asset	Accounting gains are > taxable profits Must provide for deferred tax to bring tax expense **up to** level of tax based on accounting profit	Taxable Other difference	Provide Deferred tax liability
Entertainment Expenses	Expenses included for accounting	Expense is NOT tax deductible	Accounting profits are < taxable profits	Permanent difference	No deferred taxation on permanent differences
Share Options	Share options expensed when Granted	Share options Tax deductible when exercised	Accounting profits are < taxable profits Must provide for deferred tax relief to bring tax **down to** level based on accounting profits	Deductibe Timing difference	Provide Deferred tax asset

Tax Rates and Discounting

Deferred tax liabilities are taxed at current rates and any balances carried forward from previous years are updated to reflect changes in tax rules and rates. Deferred tax balances are never discounted. The reason given for this is that the effort necessary to identify the timing of reversals of timing differences would far outweigh any benefit from its application. Although this helps to ease the accounting for deferred taxation it is an area that gives rise to a wider issue that being the inconsistency this presents in the application of discounting principles across all accounting standards.

2. Additional deferred taxation entries for Groups.

And it doesn't end there. Further deferred taxation may arise when business combinations are introduced. In a business combination, it is not the group itself that is taxed (the group is not a separate legal entity). Instead tax is levied on each of the individual entities of the group. However there are additional deferred taxation issues that may affect the group members. The most common effects include:

Item (examples)	Account Base	Tax Base	This means	This is Known as	Accounting
Valuation of assets and liabilities in a business combination	Assets and Liabilities measured at fair value	tax base is original cost	If fair value > taxation values for assets/liabilities, then accounting gains> taxable profit Must provide for deferred tax to bring tax expense **up to** level of tax based on accounting profit/gains	Taxable Timing difference	Provide Deferred tax liability
Goodwill on the acquisition of an entity	Difference between fair value of assets/liabilities and purchase consideration	Goodwill is not recognised for tax purposes	Difference is considered temporary but specific exemption under IAS12.15(a)	No Deferred Taxation	Not applicable
Carrying amount of investments in subsidiaries, associates and joint venture	Calculated as the investor share of net assets of the investee plus purchased goodwill	Cost of the investment	Differences are temporary but no deferred taxation applied only to t extent that the entity is able ot control the timing of the reversal of the differences and it is probable that the reversal will not occur in the forseeable future. IAS12.39	No Deferred Taxation	Not applicable
Unrealised profit on intercompany trade	unrealised profit eliminated on consolidation	Tax base is the transfer price of items	Accounting profits are < taxable profits Must provide for deferred tax relief to bring tax **down to** level based on accounting profits	Deductibe Timing difference	Provide Deferred tax asset

3. And finally the other transactions and events

And finally there are other miscellaneous transactions and events that may/may not give rise to deferred taxation liabilities/assets. These may include:

Item (examples)	Account Base	Tax Base	This means	This is Known as	Accounting
Unused tax losses	Losses recognised as incurred	Losses are carried forward to be set against future taxable profits	Accounting profits are < taxable profits Must provide for deferred tax relief to bring tax **down to** level based on accounting profits However entity must provide evidence which supports the conclusion that future profits will arise (ESMA Public Statement 2019)	Deductibe Timing difference	Provide Deferred tax asset
Initial cost of an asset/ liability other than in a business combination	Carrying value is included in asset/liability	Tax base is nil as no effect on taxable income	Accounting > Taxation so should provide deferred tax on temporary taxable timing difference. However no deferred taxation if transaction affects neither accounting profit or taxable profit IAS12.15(b)(ii) Eg non taxable government grant	No Deferred Taxation but note ED 2019	Not applicable

ESMA Public Statement: *Considerations on Recognition Deferred Tax Assets Arising from the Carry Forward of Unused Tax Losses.*

IASB ED 2019 : *Deferred tax related to assets and liabilities arising from a single transaction*

The Final Comment

As was mentioned at the outset of this teaching note IAS12 has been the subject of much review, comment and revision. In 2019 alone, there was further development in this area with the publication of three separate statements on this area. On a wider scale IASB have recently decided to keep International Accounting Standard 12 *Income taxes* (IAS 12) unchanged. At the same time, it also announced that it will halt any further research efforts into whether this standard should be fundamentally changed. The IASB took this decision after reviewing the results of a research project aimed at better understanding the needs of users of financial statements. This project was identified as part of the 2011 Agenda Consultation, at a time when there was increased attention on the shortcomings of IAS12

However, given what has gone before this, something tells me that the IAS12 story is not over yet.