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LKAS 12 : Income Taxes

Chartered Accountancy
Strategic Level
Advanced Business Reporting (ABR)

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LKAS 12 – *Income taxes*

LKAS 12 – Income tax

Basic Principles

- Recognize tax effects of transaction when transaction takes place

- Recognize tax effect in
  - P&L if txn is in P&L
  - Equity if txn is in equity

Current tax – Tax on taxable profits

- Tax on current year profits
- Under / Over provision
- Payments
- Resulting receivables / payables

Deferred tax on Temporary Differences (T/D)

- Arises when carrying amount is different from tax base
- Tax base
  - On assets – amount deductible for tax purposes when the carrying amount is recovered
  - On liabilities – Carrying amount less amount deductible for tax purposes when the liability is settled

T/D's and resulting deferred tax

- Taxable T/D – results in tax payments in future when the difference reverses
  - For assets when CA > TB
  - For liabilities when CA < TB
- Deductible T/D – results in recovery of tax when the difference reverses
  - For assets when CA < TB
  - For liabilities when CA > TB
- T/D x Tax rate = Deferred tax amount
  - T/T/D x Tax rate = D/T Liability
  - D/T/D x Tax rate = D/T Asset
- No discounting

LKAS 12 – Income tax (cont.)

Tax rate

- Use tax rate that will apply when the T/D reverses
- If taxed at multiple rates use weighted average rate – e.g. low and high tax rates for proportion of profits
- If taxed at specific rates use that rate – e.g. Capital Gain tax

Other topics

- Tax losses and recognition of DTA
- DT on revaluations
- DT on Business Combinations
- DT on undistributed profits of Sub / Asso / JCE

Presentation of DT

- In S/F/P
  - Present as non current items
  - No netting off of DTA and DTL unless its with the same tax authority and have a legal right to net off
- In S/C/I
  - If related txn in P&L – in P&L
  - If related txn in OCI – in OCI

Income tax

=

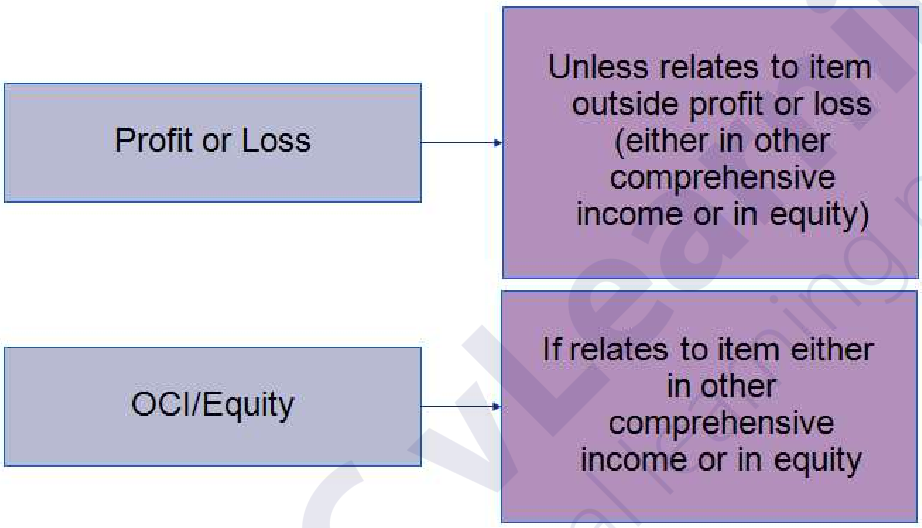
Current tax + **Deferred tax**

Summary of general rules

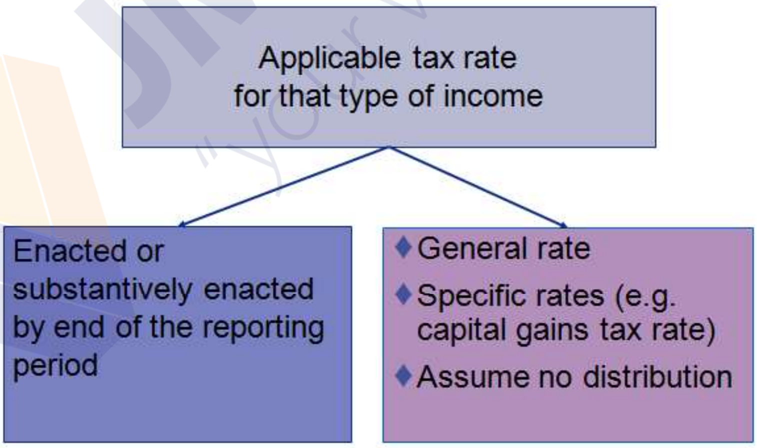
- **Deferred tax is recognised when there are temporary differences**
  - Difference between the carrying amount of an asset/liability and its tax base
- **Initial recognition exemption is applicable to:**
  - Goodwill (taxable temporary differences), or;
  - An asset or liability in a transaction which is not a business combination and at the time of the transaction, affects neither accounting profit nor taxable profit (loss)
- **Measure income taxes using tax law and tax rates that have been enacted or substantively enacted by the end of the reporting period**
- **Income tax is accounted for in the same way as the underlying transaction or event**
  - Profit or loss, OCI / equity or goodwill
- **No discounting permitted for deferred tax**
- **Deferred tax assets recognition is limited**
  - to the extent that it is probable that taxable profit will be available against which the deductible temporary differences can be utilised
- **Extensive disclosures to be given**

1.) **Recognition of current tax**

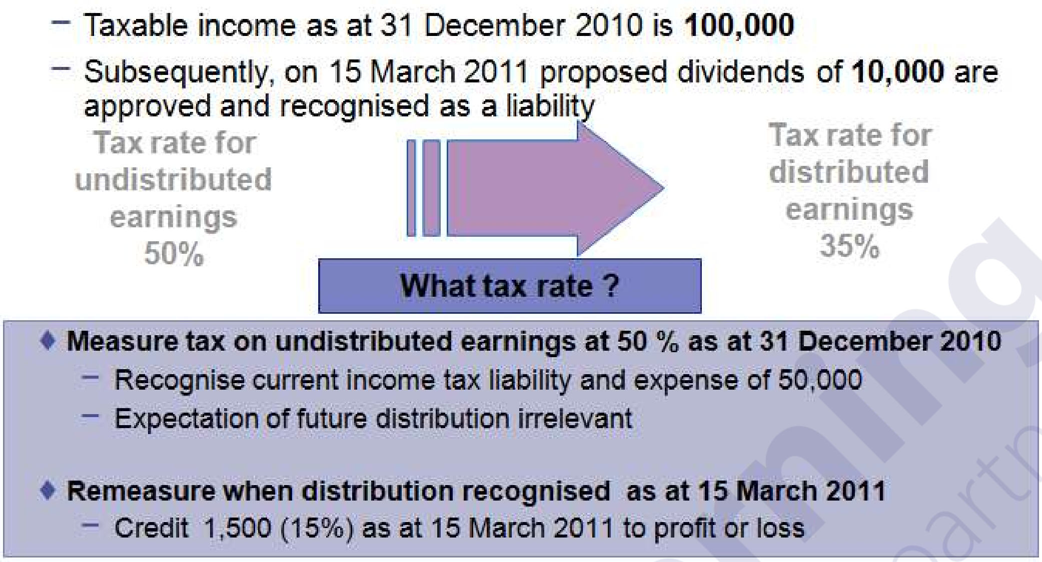
- In the statement of financial position current tax for current and prior periods should be recognised as an asset or liability
- Tax payable = liability
- Tax paid but recoverable = asset
    - Tax assets may arise in some jurisdictions through the ability to redeem current period tax losses against tax paid in earlier periods



2.) **Measurement of current tax**



Distribution of profit – Example



3.) **Deferred taxes**

3.1) Example – Scenario (1)

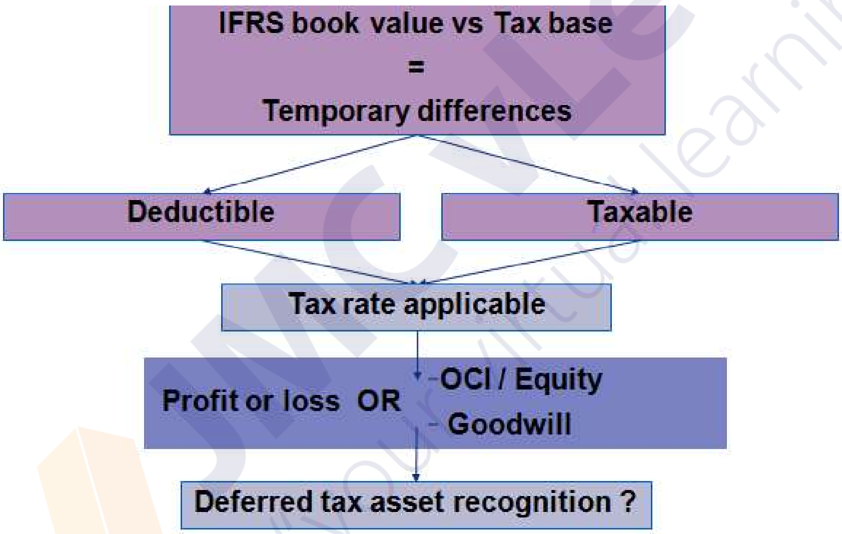
- Intial cost of a building: 120
- Useful life: 3 years (tax) vs 6 years (accounting)
- Tax rate: 40%
- Annual profit before taxes and depreciation: 200

How is income tax calculated?

Year	1	2	3	4	5	6
Profit before depreciation and tax	**200**	**200**	**200**	**200**	**200**	**200**
Depreciation expense	**(20)**	**(20)**	**(20)**	**(20)**	**(20)**	**(20)**
Profit before tax (PBT)	**180**	**180**	**180**	**180**	**180**	**180**
Current tax expense (CTE)	**(64)**	**(64)**	**(64)**	**(80)**	**(80)**	**(80)**
Effective tax rate (CTE/PBT)	**36%**	**36%**	**36%**	**44%**	**44%**	**44%**
Net profit	**116**	**116**	**116**	**100**	**100**	**100**

Year	1	2	3	4	5	6
Building, tax base	80	40	-	-	-	-
Building, carrying amount	100	80	60	40	20	-
Temporary difference	20	40	60	40	20	-
Deferred tax liability	8	16	24	16	8	-
Deferred tax expense	8	8	8			
Deferred tax income				(8)	(8)	(8)
Current tax expense	64	64	64	80	80	80
Income tax expense	72	72	72	72	72	72
Profit before tax	180	180	180	180	180	180

3.2) Deferred tax: overview

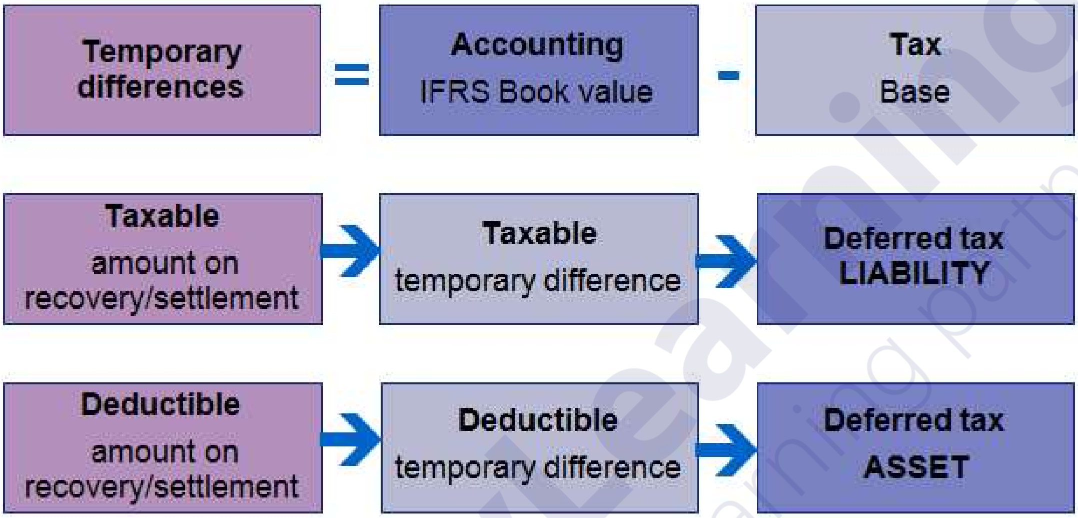


3.3) **Tax base**

- **The tax base of an item is the amount attributed to that item for tax purposes**
- **Tax base of an asset:**
  - Amount deductible for tax purposes when the asset is recovered
  - Example:
    - Interest receivable of 100 (carrying amount)
    - Related interest revenue are taxed on a cash basis.
    - Tax base is nil
  - Example:
    - A motor vehicle cost 100 and is depreciated by 20 and SLFRS carrying amount is 80
    - On this asset in the previous year a depreciation allowance of 40 has been claimed
    - When the carrying amount of 80 is recovered (either by using or by disposal) the amount deductible for tax purposes will be only 60
    - Therefore tax base is 60
- **Tax base of a liability:**
  - Carrying amount less any amount that will be deductible for tax purposes in respect of that liability
  - Example:
    - Loan payable of 100 (carrying amount)
    - Repayment of the loan has no tax consequences
    - Tax base is 100
  - Example:
    - Provision for bonus to employees 100 (carrying amount)
    - For tax purposes the bonuses are deductible only when it is paid

- Therefore tax base is 100 (carrying amount) less 100 (amount deductible for tax purposes when the liability is settled)
- Tax base of Bonus provision is 0

3.4) **Temporary differences**



3.4.1) **<u>Taxable</u> temporary difference – Situation 1**

- **PPE with original cost of 150**
  - Accounting treatment: depreciate straight line to zero residual value over 5 years
  - Tax treatment: original cost tax deductible straight line over 3 years
- **At end of year 1**
  - Accounting: carrying amount = 120
  - Tax: tax base = 100
- **Taxable temporary difference: 120 – 100 = 20**
- **Deferred tax liability**

3.4.2) **Deductible temporary difference**

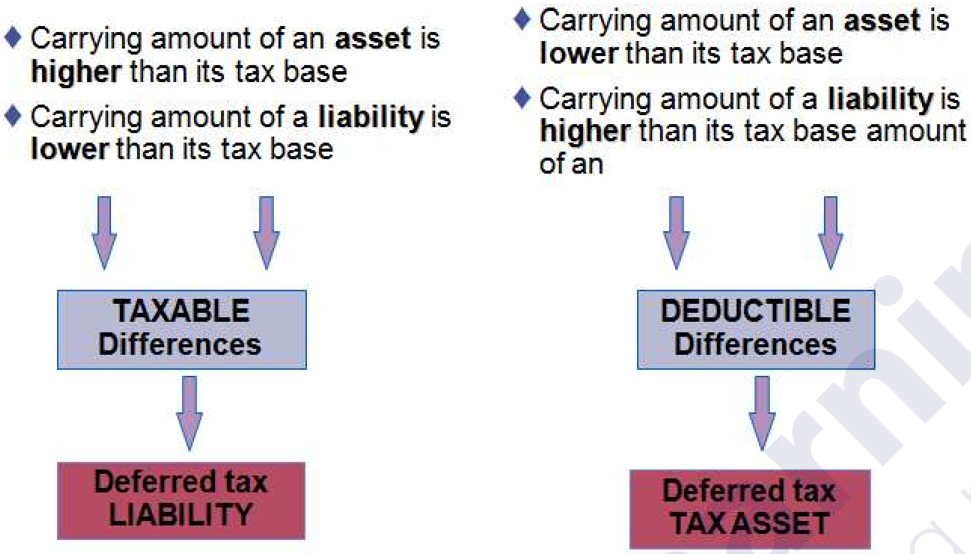
– Situation 1

- **PPE with original cost of 100**
  - Accounting treatment: depreciate straight line to zero residual value over 4 years
  - Tax treatment: original cost tax deductible straight line over 5 years
- **At end of year 1**
  - Accounting: carrying amount = 75
  - Tax: tax base = 80
- **Taxable temporary difference: 75 – 80 = 5**
- **Deferred tax liability**

– Situation 2

- **Warranty provision of 100**
  - Accounting treatment: expense as incurred
  - Tax treatment: tax deductible upon reversal (when claims are actually paid)
- **Immediately after incurred**
  - Accounting: carrying amount = 100
  - Tax: tax base = 0
- **Deductible temporary difference: -(100 – 0) = 100**
- **Deferred tax asset**

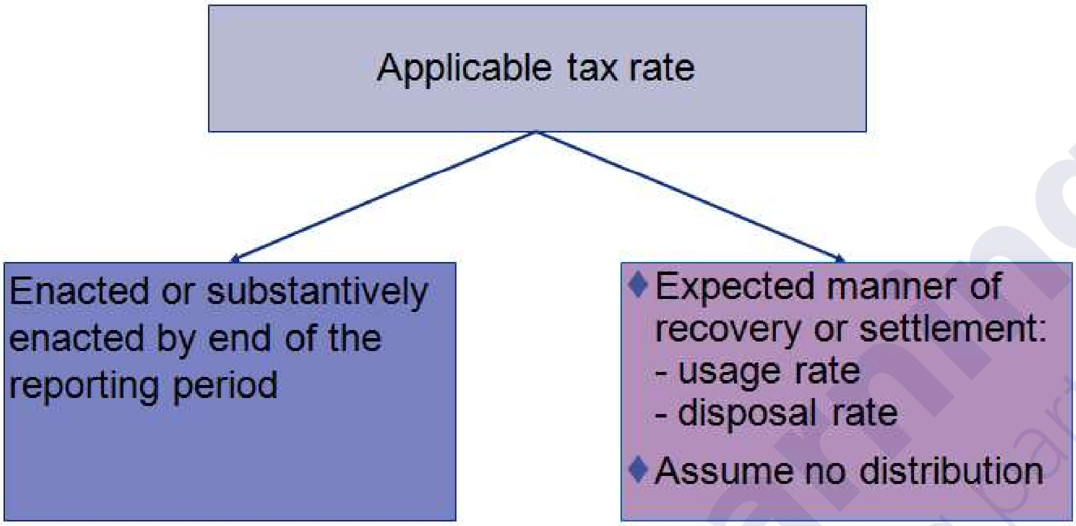
3.4.3) Temporary differences – Summary



3.5) Exceptions to recognition of deferred taxes

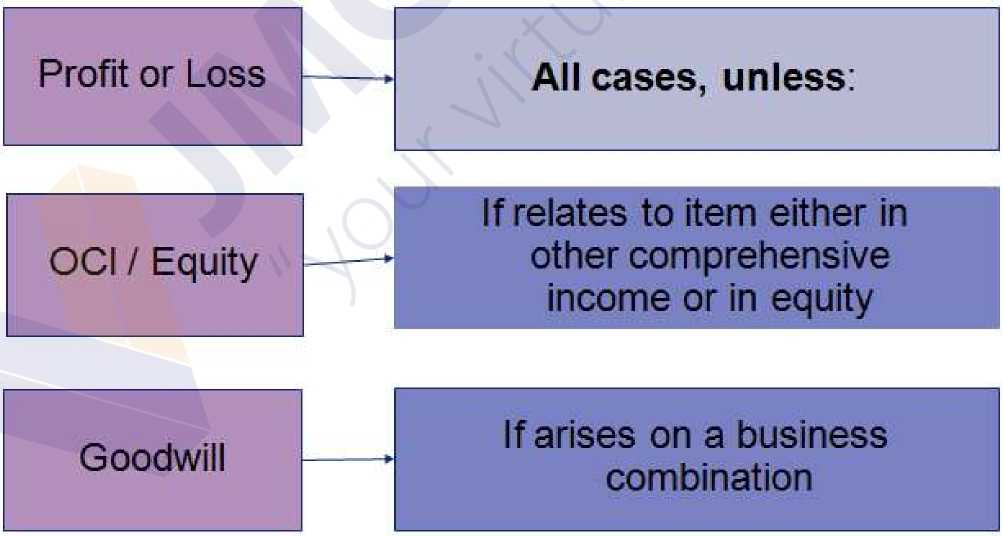
- **<u>Taxable</u> temporary differences arising from the initial recognition of goodwill**
- **Temporary differences arising from the initial recognition of an asset/liability in a transaction which:**
  - Is not a business combination
  - Does not affect accounting nor taxable profit at that time
- **Temporary differences arising from investments when**
  - Parent has control of the timing of reversal AND it will not reverse in the foreseeable future

3.6) **Measurement of deferred tax**



Measurement – No discounting

3.7) Recognition of deferred tax



3.8) Recognition of deferred tax asset / liability

- Liability - Recognise in full

- Asset - Recognise if recoverable

3.9) **Deferred tax asset – Examples**

- Deductible temporary differences
- Unused tax losses
- Unused tax credits

3.10) Asset recognition: When?

- **Sufficient taxable profit:**
  - Taxable temporary differences
  - Taxable profits
  - Tax planning opportunities

3.11) Deferred tax asset recognition – To what extent?

Company	DTA (based on tax loss 400 x tax rate 25%)	Forecast taxable profit for 3 years	Recognised DTA
A	100	500	100
B	100	(200)	0
C	100	80	?

4.) **Presentation**

- **Minimum line items to be presented separately in the statement of financial position**
  - Current tax assets and liabilities
  - Deferred tax assets and liabilities
- **Deferred tax assets/liabilities to be classified as non current items in a classified statement of financial position**
- **Tax expense to be presented separately in the statement of comprehensive income**

4.1) Presentation – Offsetting

- **Current tax assets/liabilities offset only if**
  - Legally enforceable right; and
  - Intention to settle on a net basis or simultaneously
- **Deferred tax assets/liabilities offset only if**
  - Legally enforceable right to off-set current tax assets and liabilities; and
  - Income taxes relating to same taxation authority and from:
    - The same taxable entity
    - Different taxable entities intending to settle/realise net or simultaneously

5.) **Disclosures**

- Reconciliation of effective rate to statutory tax rate
- Major components of tax expense (income)
- Income tax recognised outside profit or loss:
  - Aggregate amount recognised directly in equity
  - Amount relating to each component of OCI
- Explanation of changes in tax rates compared to previous year
- Evidence for the amounts of deferred tax asset recognised when
  - Dependent on future taxable profit
  - The entity has suffered a loss in the current or previous period

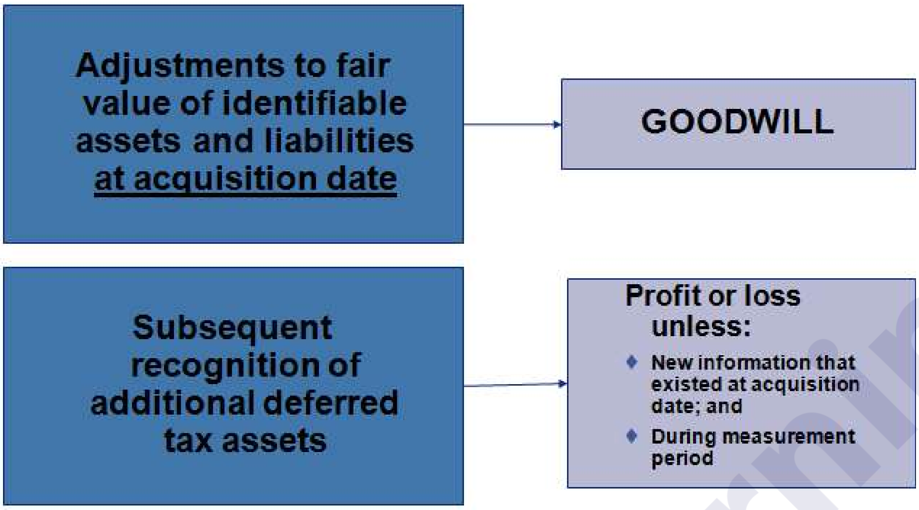
- Amounts recognised in respect of each type of
  - Temporary differences, unused tax losses and unused tax credits
  - Deferred tax assets/liabilities
  - Deferred tax income/expense in P&L, OCI / Equity
- Unrecognised deferred tax assets
  - Amount and expiry date of deductible temporary differences, unused tax losses and unused tax credits for which no deferred tax asset is recognised
- Unrecognised deferred tax liabilities
  - Amount of temporary differences on investments in subsidiaries, associates and JV not recognised
  - Potential tax consequences of payments of dividends to shareholder

6.) Special Issues

6.1) **Business combinations – Initial accounting**

- **General principles:**
  - Temporary differences arise on fair value and other adjustments made as part of the acquisition accounting
  - The deferred tax position of acquirer and acquiree is reassessed at the date of acquisition
  - Resulting deferred tax affects goodwill
- **Exceptions:**
  - Deferred tax liability arising from initial recognition of goodwill not recognised
  - Change in the deferred tax positions of the acquirer due to the acquisition is recognised in P&L

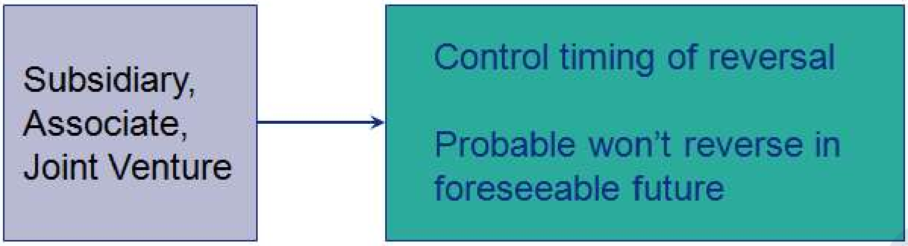
Business combinations – Subsequent adjustments



6.2) **Investments – General rule**

- **Temporary differences:**
  - Consolidated subsidiaries, associates and joint ventures:
    - undistributed profits
    - changes in foreign exchange rate
    - reduction of carrying amount to recoverable amount
    - Etc.
  - Non-consolidated investments:
    - Changes in fair value

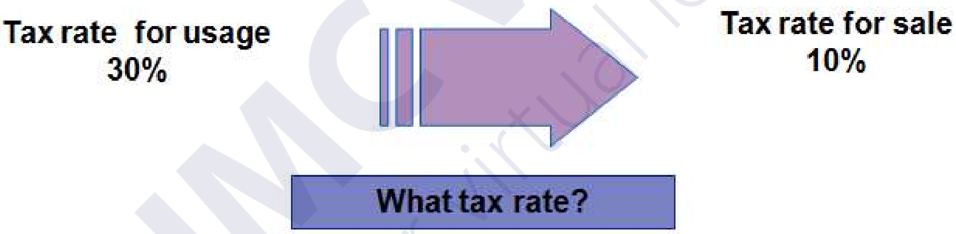
Investments – Exception to the general rule



Unlikely for associates and JVs unless contractually agreed

6.3) **Dual intention**

- In many cases, an entity may have a dual intention for an asset, e.g. to use an asset and then to sell it



- Calculate deferred tax based on the expected manner of recovery or settlement using a "blended rate"

<u>Quiz</u>

- **Company A reported pre-tax accounting income of 90,000, but due to temporary differences arising in the year, taxable income is only 50,000. Assuming a tax rate of 40%, statement of comprehensive income should report net income of:**

  A. 70,000

  B. 40,000

  C. 30,000

  D. 54,000

- **Assume that Company C has accrued several speeding fines for its salespeople. Fines are never deductible for tax purposes. This will result in which of the following?**

  A. Deductible temporary difference and future income tax liability

  B. No temporary difference

  C. Taxable temporary difference and future income tax liability

  D. Taxable temporary difference and future income tax asset

- **With respect to deferred taxes:**

1. Deferred tax liabilities and assets must be offset if the entity has a legally enforceable right to offset current tax liabilities and assets, they relate to taxes levied by the same tax authority and the entity intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously;

2. Deferred tax assets and liabilities have to be discounted.

   A. 1 is true, 2 is false

   B. 1 is false, 2 is true

   C. 1 is true, 2 is true

   D. 1 is false, 2 is false

Practice questions

Q1

Given below are the details of assets and liabilities of ABC Ltd as at 31-12-2020

Item	Carrying amount	Tax Base
Land	10,000	10,000
Buildings	8,000	6,000
Machinery	12,000	13,000
Motor vehicles	5,000	2,000
Intangible asset – patent	1,000	400
Provision for gratuity	1,500	0

Required:

1.) Calculate the temporary difference and determine whether it is a taxable temporary difference or a deductible temporary difference
2.) If the applicable tax rate is 14% calculate the deferred tax asset / liability as at 31-12-2020
3.) If the opening balance of deferred tax is an asset of 100 determine the charge / reversal to the P&L

Q2

Given below are information relating to the carrying amounts of items as at 31-3-2020 and the information to determine the tax base of those items.

Item	Carrying amount
Land	15,000
Buildings	10,000
Machinery	4,000
Motor vehicles	3,000
Intangible asset – patent	1,500
Software	500
Provision for gratuity	2,000
Provision for penalties	300
Provision for bad debt – specific	500
Provision for bad debt – collective	300

- No depreciation allowance is claimable on lands
- Buildings were purchased in 2017/18 at a cost of 15,000 and depreciation allowance for tax purposes is claimable over 20 years

- Machineries were purchased in 2016/17 at a cost of 6,000 and depreciation allowance is claimable over 8 years
- Motor vehicles comprise of vehicles used by the directors of the company and no depreciation allowance is claimable
- Intangible asset was acquired in the current year at a cost of 2,000 and is claimable over a period of 10 years
- The company purchased a locally developed software for a price 600 during the year and it is being amortized over 6 years. Locally developed software cost is claimable in full in the year of purchase
- Provision for gratuity is not deductible for tax purposes. However, the payment of gratuity is deductible in the year it is paid. During the year movement is as follows

Opening balance	- 1,500
Provision for the period	- 800
Paid	- (300)
Closing balance	- 2,000

- The company incurred 700 as research expenses and recognized it as expenses in the current period. however, for tax purposes these are claimable over a period of 4 years
- The company had brought forward tax losses and the movement of such losses were as follows.

Opening balance	- 300
Utilized during the period	- (50)
Balance CF	- 250

Required:

1.) Calculate the temporary difference and determine whether it is a taxable temporary difference or a deductible temporary difference
2.) If the applicable tax rate is 28% calculate the deferred tax asset / liability as at 31-3-2020
3.) If the opening balance of deferred tax is a liability of 500 determine the charge / reversal to the P&L

Q3

P Ltd acquired 80% of S Ltd on 1-1-2015 at a price of 100,000. The assets and liabilities of S on the acquisition date were as follows.

	S Ltd
	Rs.'000
PPE	80
Trade receivables	15
Cash	5
Total assets	100
Stated capital	50
Retained earnings	20
Deferred tax liabilities	10
Other Liabilities	20
Total equity and liabilities	100

The fair value of PPE items on the acquisition date was 100,000 with a remaining useful life of 10 years and the increase in the fair value causes a temporary difference. The company has provided for the temporary difference between the existing carrying amount and the tax base in its financials. No adjustments have been made for the fair value adjustments. The company is liable at a tax rate of 20%.

Required –

1.) Calculate the goodwill of the company
2.) If the year-end retained earnings of S was Rs. 35,000 and P was 50,000, calculate the group retained earnings
3.) Show extracts of the group statement of financial position as at 31-12-2015

December 2013
Question 2

(d) The following information was extracted from the 2012/2013 financial statements of Hiru Plc.

Carrying value of property, plant and equipment as at 31 March 2013		Rs.260 million
Tax base of the property plant and equipment	as at 31 March 2013	Rs.140 million.
Retirement benefit obligations	as at 31 March 2013	Rs. 26 million.
Retirement gratuity paid during the year 2012/2013		Rs. 3 million.
New product development cost incurred during the year		Rs. 6 million.
Deferred tax liability as at 31 March 2012		Rs. 32 million

Retirement benefit obligations are deductible only when the payment is made. New product development cost incurred above was capitalized as an intangible asset as it satisfied the conditions stipulated in the Sri Lanka Accounting Standards. The company expects to amortize this cost over a period of four years. However this expenditure is deductible for tax purpose in full during the year ended 31 March 2013. Tax rate applicable to the company is 28%.

Compute deferred tax liability / asset to be recognized in the financial statements of the company for the year ended 31 March 2013.
(5 marks)

Practice questions

Q1

b) In the consolidated financial statements for 2015, Chemclean recognised a net deferred tax asset of Rs.16 million, which represented 18% of its total equity. This asset was made up of Rs.3 million taxable temporary differences and Rs.19 million relating to the carry-forward of unused tax losses. The local tax regulation allows unused tax losses to be carried forward indefinitely. Chemclean expects that within five years, future taxable profits before tax would be available against which the unused tax losses could be offset. This view was based on the budgets for the years 2015-2020. The budgets were primarily based on general assumptions about the development of key products and economic improvement indicators. Additionally, the entity expected a substantial reduction in the future impairment of trade receivables and property which the entity had recently suffered and this would result in a substantial increase in future taxable profit.

Chemclean had recognised material losses during the previous five years, with an average annual loss of Rs.19 million. A comparison of Chemclean's budgeted results for the previous two years to its actual results indicated material differences relating principally to impairment losses. In the interim financial statements for the first half of the year to 30 June 2015, Chemclean recognised impairment losses equal to budgeted impairment losses for the whole year. In its financial statements for the year ended 30 June 2015, Chemclean disclosed a material uncertainty about its ability to continue as a going concern. The current tax rate in the jurisdiction is 30%.

Discuss whether Chemclean could recognize the deferred tax asset (9 marks)

CA Sri Lanka – Corporate Level – June 2016

Question 1 – part 1

Deferred Tax

(i) No adjustment for deferred tax had been done in the draft financial statements. As worked out by the previous accountant, CTP had a taxable temporary difference of Rs. 196,700 resulting from property, plant and equipment (PPE). The building was revalued at the year end and the resulting revaluation surplus was Rs. 1.5 million and this has not been considered when calculating the temporary difference above.

(ii) As at 31 March 2016, the company's carried forward tax losses amounted to Rs. 2.5 million including the current year tax losses. Based on the workings relating to the interim period after the year end, tax losses would be available in the next year as well.

CTP pays corporate tax at 28%.

Evaluate the implications of the transactions in (1) above relating to deferred tax, on the financial statements for the year ended 31 March 2016. (10 marks)

CA Sri Lanka – Corporate Level – June 2018

Question 1

(c) You have been provided with the following deferred tax computation of John & Co. (Pvt) Ltd.

	Carrying amount	Tax base	Temporary difference	Deferred tax at 28%
	Rs.'000	Rs.'000	Rs.'000	Rs.'000
Property, plant and equipment	650,120	453,001	197,119	55,193
Goodwill	25,700	-	25,700	7,196
Unused tax credits and losses	-	851,230	(851,230)	(238,344)
Deferred tax asset				**175,955**

Additional information

1.) Property, plant and equipment include land and building carried at revalued amount. However, no equivalent adjustment to the cost of the assets will be required for tax purposes. The company claims capital allowances for the building. If the land and building are disposed, the gain arising thereon is subjected to tax at the normal rate. Revaluation gains relating to this land and building of Rs. 175 million, has been excluded in computing the above deferred tax liability since the company does not intend to sell these assets.

2.) Goodwill has arisen from an acquisition of a subsidiary during the year

3.) John & Co. (Pvt) Ltd has a history of recent tax losses

Required:

Compile a briefing note to the management of John & Co. (Pvt) Ltd on the accuracy of the above deferred tax computation. Your briefing note should include any adjustment to the above computation and the final net deferred tax liability/asset.

(8 marks)

CA Sri Lanka – Corporate Level – June 2019

Question 1

(c) Ram PLC (Ram) is in the process of preparing its financial statements for the year ended 31 March 2019. The following matters are pending relating to deferred taxation. Ram's current income tax rate is 12%. However, this rate will be changed to 10%, with effect from 1 April 2019, as enacted by the new tax legislation.

(i) Investment property acquired on 1 April 2017 for Rs. 13 million has been valued for Rs. 16 million on 31 March 2019. The valuation does not affect the taxable profit. Ram measures investment properties at fair value. Ram depreciates this property over 15 years for tax purposes. If the investment property is sold, a tax rate of 20% would apply on the sales proceeds in excess of the cost. However, reversal of tax depreciation already claimed, will be taxed at the normal income tax rate. Ram expects to sell this property in the 5th year of its useful life.

(ii) Ram has motor vehicles amounting to Rs. 25 million. Ram cannot deduct depreciation allowance on these vehicles for tax purposes, and disposal gains are not taxable.

(iii) Ram has recognised a provision for product warranty cost, amounting to Rs. 3 million. These costs will not be taxable, until the claims are paid.

Required:

Advise on the financial reporting treatment based on the requirements of LKAS 12, Income Taxes for the year ended 31 March 2019.

(12 marks)