

# IFRS News

Emerging issues and practical guidance\*

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## Beginners' guide: nine steps to income tax accounting



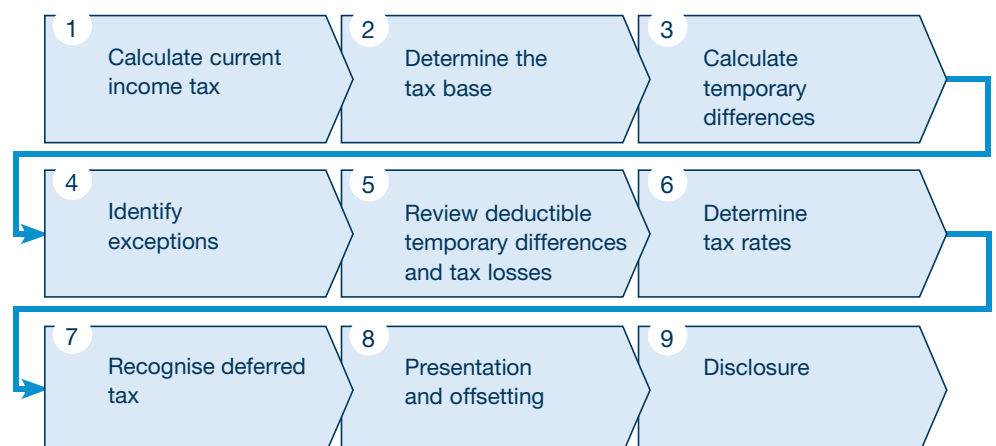
Deferred tax is not the most glamorous of accounting topics, but there is more to it than meets the eye. Bill Maloney of PwC's Global Accounting Consulting Services central team explains the logic behind deferred tax accounting and a nine-step approach to making it work<sup>1</sup>.

Profit for accounting purposes and profit for tax purposes are seldom the same number, even in the most simple of companies. The book value of an asset or liability is often different from the amount assigned to that asset or liability for tax purposes; or they impact the income statement at different times. Think of deferred tax accounting as constructing a balance sheet based on IFRS and a corresponding tax balance sheet based on tax laws. The difference between the two balance sheets, measured at the right tax rate, means that the accounting profit or loss in any period may be different from the taxable profit or loss in the same period.

A company may end up paying tax when it recovers (for example, uses or sells) an asset or settles (for example, pays or transfers to a third party) a liability for its book (carrying) amount and there is no accounting profit or loss. Deferred tax accounting is designed to deal with this situation; management recognises deferred taxes based on these differences.

This beginner's guide sets out a simple nine-step approach to calculating deferred tax. Armed only with this methodology and the tax code, we hope to shed light on what can be the most opaque of assets or liabilities in the balance sheet.

### Nine-step approach to calculating deferred tax



<sup>1</sup> Publishers note: there were so many potential puns and jokes in this beginners' guide that we had to do the only safe thing and leave them all out for fear of confusing the readers. So, we will pass silently over 12-step programmes, those who develop expertise in deferred tax and those of us who, while enlightened by this beginners' guide, now know more than we wanted to.

Let's use a fictional company, Widget Ltd, to illustrate the nine-step process. Widget began operations on 1 January 2008. Its book and tax financial statements are consistent except for two items explained below:

- Widget purchased a piece of equipment on 1 January 2008 for C200. The equipment has a useful life of four years and is depreciated on a straight-line basis (that is, evenly over the period) in the book balance sheet. The tax authority allows Widget to claim tax deductions for the cost of the equipment over two years, also on a straight-line basis.
- Widget records a warranty provision on its book balance sheet when revenue is recognised. The tax authority does not allow a deduction for the warranty expense until cash is paid to settle a warranty claim.

The tax rate in Widget's jurisdiction is 40%.

### Step one: Calculate current income tax

Income tax expense is comprised of two parts: current tax and deferred tax. The first step is to calculate current tax by determining taxable profit for the period and multiplying that profit by the applicable tax rate. Widget Ltd recognises C1,000 of revenue for both book and tax purposes during the first year of operations. It also records book depreciation of C50 (C200/4) and warranty expense of C120. It does not pay any cash to settle warranty claims. Widget's book profit before considering income tax expense is C830. Widget claims a tax deduction of C100 for depreciation. Widget's taxable profit as shown on the tax return is C900.

	Book f/s	Tax f/s
Revenue	1,000	1,000
Depreciation	-50	-100
Warranty	-120	0
Income before tax expense	830	900

Applying a tax rate of 40% to the taxable profit results in current income tax expense of C360.

### Step two: Determine the tax base

The next step is to build the tax balance sheet. A tax value or 'tax base' is assigned to each asset and liability on the accounting balance sheet. There may also be items on the tax balance sheet that do appear in the accounting balance sheet. The tax base reflects the tax consequences that will occur when the carrying amount of an asset or liability is recovered or settled – how much will be deducted for tax purposes when the asset is sold or the liability is paid? Understanding what will happen for tax purposes when the asset is sold or otherwise 'used up', or when the liability is settled, is critical to determining the tax base. For example, if management expects to recover the carrying value of a piece of equipment by using

the equipment, the tax base is the expected tax deduction for the depreciation of that asset. If management expects to recover the carrying value by selling the equipment, the tax base is the expected tax deduction when the asset is sold.

The tax base of Widget's equipment is C200 when it is purchased because the tax authority will provide a deduction for the cost of the equipment. After the first year, the tax base is equal to the remaining unused deduction, or C100. The tax balance sheet does not include a liability for warranty costs because they are only deductible when the cash is paid. The tax base of the warranty provision is therefore nil.

### Step 3: Calculate temporary differences

This step is simple. Compare the carrying value of each asset or liability to the corresponding tax base and calculate the difference. A temporary difference is 'taxable' if it results in the payment of additional tax; it is 'deductible' if it results in an additional tax deduction. Temporary differences arise as follows:

	Deductible temporary difference (deferred tax asset)	Taxable temporary difference (deferred tax liability)
Assets	Tax base > carrying amount	Carrying amount > tax base
Liabilities	Carrying amount > tax base	Tax base > carrying amount

Widget Ltd has a taxable temporary difference of C50 for the equipment (book carrying amount of C150 is greater than the tax basis of C100). Widget also has a deductible temporary difference of C120 for the warranty provision (book carrying amount of C120 is greater than the tax base of nil).

	Equipment	Warranty
Book carrying amount	150	120
Tax base	100	0
Deductible temporary difference	N/A	120
Taxable temporary difference	50	N/A

At the end of the second year (31 December 2009), the taxable temporary difference on the equipment will increase to C100 because Widget will record an additional C50 of book depreciation, and the new carrying amount will be C100. Widget will claim an additional C100 of tax depreciation, and the tax base will be nil. During the third and fourth years, the taxable temporary difference will reverse. Widget will continue to record book depreciation of C50 each year to lower the book carrying amount, but it will no longer receive any tax deductions for the equipment and will pay more tax as a result. The deductible temporary difference of C120 for the warranty provision will reverse when cash is paid to settle warranty claims. The cash payment is deductible for tax purposes when paid.

**Step 4: Identify exceptions**

Deferred tax is recognised for all temporary differences, subject to three exceptions as described in the following paragraphs.

**Initial recognition of an asset or liability**

Deferred tax is not recognised when an entity acquires an asset or liability outside a business combination and in a transaction that does not affect accounting profit or taxable profit. For example, if a company acquires an asset for C100 and the tax authority provides a deduction of only C60, a taxable temporary difference C40 exists. Recording a deferred tax liability would increase the carrying amount of the asset, which would increase the temporary difference and require an additional deferred tax liability. The resulting calculation results in a gross-up of the asset and the deferred tax liability. This gross-up is seen as making the financial statements less transparent. Entities are not permitted to recognise deferred taxes in this situation.

**Non-deductible goodwill arising in a business combination**

Goodwill is a residual amount, and recognising a deferred tax liability would increase goodwill, which in turn would impact the temporary difference. Again, the iterative calculation would gross up goodwill and the deferred tax liability, and IAS 12 does not permit recognition of the deferred tax liability.

**Investments in subsidiaries and associates**

The carrying amount of an investment in a subsidiary or associate may differ from the tax base. This difference may arise for a number of reasons, including unremitted earnings, currency translation adjustments, or unrealised gains and losses on available-for-sale securities held by the subsidiary or associate. Deferred taxes have to be recognised for any temporary difference associated with investments in subsidiaries and associates unless the investor is able to control the timing of the reversal and it is probable that the temporary difference will not reverse in the foreseeable future.

Widget is not subject to any of these exceptions.

**Step 5: Review deductible temporary differences and tax losses**

Deferred tax liabilities are always recognised for taxable temporary differences, subject to the exceptions described above. Widget should therefore recognise a deferred tax liability associated with its equipment. Deductible temporary differences, however, should be recognised as deferred tax assets only to the extent it is probable that future taxable profits will be available against which the deductible temporary difference can be used. Future taxable profits arise from three main sources as described below.

**Taxable temporary differences**

An entity should first consider the reversal of existing taxable temporary differences. Taxable profits will increase when

these temporary differences reverse, and if they are expected to reverse in the same period as the deductible temporary differences, relate to the same taxation authority and will provide the appropriate type of income (for example, ordinary versus capital), the related deferred tax asset should be recognised.

**Future trading profits**

Second, an entity should consider whether its ongoing operations will generate sufficient taxable profits (exclusive of the reversing taxable temporary differences) to utilise deductible temporary differences. This analysis requires careful consideration, particularly when an entity has a recent history of losses. What caused the recent losses? What are the budgets and forecasts? How reliable have those budgets and forecasts been in the past? Why type of product is being sold and in what industry? When do the tax losses and tax credits expire? Answers to these questions will determine whether an entity can rely on expected future taxable profits.

**Tax planning opportunities**

The third source of future taxable profit comes from tax planning opportunities. Tax planning opportunities are actions an entity would not normally take but would take to realise a deferred tax asset. For example, an entity may take some action to accelerate taxable income to an earlier period to ensure a tax loss does not expire.

Widget Ltd is able to recognise at least C50 of the C120 deductible temporary difference related to the warranty provision because of the C50 taxable temporary difference related to the equipment. The recognition of the remaining deductible temporary difference depends on whether other sources of future taxable profits are available. For purposes of this example, assume Widget expects to make sufficient profits in the future from ongoing operations and is therefore able to recognise the entire deferred tax asset.

**Step 6: Determine tax rates**

The recovery of an asset or the settlement of a liability may not occur for many years. Deferred taxes should be measured at the tax rates that are expected to apply when an asset is realised or a liability is settled. Deferred tax is calculated using the rate that has been 'enacted or substantively enacted' by the end of the reporting period. In our example, the existing tax rate for Widget Ltd is 40%. If a change in tax law has been substantively enacted at the balance sheet date that will reduce the existing tax rate to 30% in 2011, temporary differences that reverse in 2009 and 2010 should be measured at 40% and temporary difference that reverse in 2011 should be measured at 30%.

**Step 7: Recognise deferred tax**

Multiply the temporary differences by the applicable tax rate and recognise the deferred tax in a manner consistent with the pre-

tax accounting. In other words, current and deferred tax should be recognised in the income statement unless the tax relates to an item that was recorded outside of the income statement (for example, in equity).

Widget will record a deferred tax liability of C20 ( $C50 * 40\%$ ) and a deferred tax asset of C48 ( $C120 * 40\%$ ) at the end of the first year. The deferred tax expense of C20 and the deferred tax benefit of C48 will be recorded in the income statement. The current tax charge of C360 (Step 1 above) is offset by the net deferred tax benefit of C28 (C48 less C20), and the total income tax expense in the IFRS financial statements is C332.

The final income statement result for Widget's first year of operations is as follows:

	<b>Book</b>
Revenue	1,000
Depreciation	-50
Warranty	-100
Income before tax	830
Income tax expense	-332
Net income	498

Notice that Widget's effective tax rate (that is, income tax expense divided by income before tax) is 40% ( $C332/C830$ ), which is consistent with the tax rate in Widget's tax jurisdiction. If only current tax had been considered, the effective tax rate would have been 43% ( $C360/C830$ ). The deferred tax benefit of C28 has the effect of 'normalising' the effective tax rate. Widget also has a deferred tax asset on its balance sheet to account for the future tax consequences of settling the warranty provision and a deferred tax liability to account for the future tax consequences of recovering the carrying amount of the equipment.

### Step 8: Presentation and offsetting

Current tax assets and liabilities can be offset and deferred tax assets and liabilities can be offset if an entity has a legally enforceable right to set off the amounts and intends to either settle them on a net basis or realise the asset and liability simultaneously. Practically speaking, offsetting can be done when the taxes relate to the same tax jurisdiction and the taxing jurisdiction permits net payment.

Deferred tax assets and deferred tax liabilities should always be presented as non-current in the balance sheet.

Widget will present a net deferred tax asset of C28 (gross deferred tax asset of C48 less gross deferred tax liability of C20) in its IFRS balance sheet at 31 December 2008.

### Step 9: Disclosure

Transparency around income tax accounting is critical. IAS 12 contains a number of disclosure requirements. Two of the more important, and often overlooked, requirements relate to deferred tax assets and deferred tax liabilities that have not been recognised. The first of these is for tax losses that are carried forward. If a deferred tax asset has not been recognised for these tax losses because it is not probable that future taxable profits will be available (See Step 5), the amount of the losses and the expiry date should be disclosed. The second disclosure is for temporary differences associated with investments in subsidiaries and associates. If a deferred tax liability has not been recognised because the company asserts it meets the criteria for the exception described in Step 4, the unrecognised amount should be disclosed. Companies should also consider including the accounting for income taxes in their critical estimates and judgements.

Does income tax accounting get more complicated than this? Not really. The fact patterns may be cryptic and the accounting guidance may seem complex, but sticking to these nine steps will keep you on the straight and narrow path to success.