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IAS® Standard 12 Income Taxes

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CASE STUDY - IAS 12 INCOME TAXES

Introduction

IFRS-based accounting must represent the economic substance of transactions, which in many cases might differ from the treatments that are acceptable from a tax perspective. The temporary differences between financial reporting and taxation are dealt with via the deferred tax mechanism; they result in the recognition of deferred tax liabilities and assets in the statement of financial position, respectively of deferred tax expenses or income in the statement of profit or loss.

The aim of this case study is to assess the consequences on the financial statements of the temporary differences that may exist between accounting and tax treatments.

The Case Information

You work in the subsidiary of a listed group. This subsidiary is located in Taxland, a country where the tax treatments traditionally prevail for financial reporting purposes as well.

Given the limited IFRS expertise in Taxland, IFRS financial statements were prepared before this year by an external consultant. However, management would like to achieve more internal involvement in understanding and preparing the IFRS financial statements. Now the managers desire to understand the consequences on the financial statements of the following accounting policies, as they are different from the ones that are accepted for tax purposes.

The main differences between accounting and taxation occur in 20X1 only for assets. This is the case for the following items:

a) a production line that was purchased 5 years ago for CU120,000. A useful life of 10 years, and a residual value of CU30,000, were estimated for financial reporting purposes for this asset, based on the estimated pattern of consumption of the asset. For tax purposes though, the production line is depreciated over 15 years (no residual value is recognised). The straight-line method is used for depreciating the asset for both reporting and tax purposes.

b) equipment that was purchased at the beginning of 20X1 for CU60,000. The entity intends to use it for 5 years. The asset should be depreciated over 4 years for tax purposes. The straight-line method is used for depreciating the asset for both reporting and tax purposes. Some indications of impairment appeared at the end of 20X1. An impairment test is conducted and an impairment loss of CU2,000 is recognised. This decrease in value is not tax deductible.

c) land that was purchased 15 years ago for CU80,000. The land was revalued at the end of 20X1 for a fair value of CU85,000. The revaluation is not accepted from a tax perspective.

d) the entity recognised prepaid expenses for CU5,000, representing rent paid in 20X1 for the months of January and February of 20X2. Rent is deductible for tax purposes on a cash basis.

e) inventories whose cost is CU16,000. Their net realisable value at the end of 20X1 is estimated at CU15,000. Any write downs are not tax deductible.

The entity has a deferred tax liability of CU500 at the beginning of 20X1. The income tax rate in Taxland is 20%.

Discussion Questions

1) Explain the context of any differences appearing between financial reporting and taxation.
2) Determine any temporary differences between financial reporting and taxation for the entity for the 20X1year.
3) What are the consequences of these differences on the financial statements of 20X1?

SOLUTION OF CASE STUDY - IAS 12 INCOME TAXES

1) Differences may exist between the items' carrying amount (their value reported in financial reporting) and their tax base (value recognised for tax purposes). Some of these differences are permanent, while others are temporary. For example, fines are not deductible from a tax perspective (in the determination of income tax paid). They are an example of permanent differences existing between the reporting and the tax treatments, respectively. However, if assets are consumed differently by the entity from what the tax authorities consider appropriate for the payment of taxes, this is a temporary difference that is reversible over time. If this is the case, then the deferred tax mechanism helps dealing with the different time effect of these treatments.
2) For assets, if their carrying amount is higher than their tax base, taxable temporary differences and deferred tax liabilities appear. This is because, in the future, when assets are recovered, their carrying amount is expensed but is not deductible in full for the determination of income tax paid (as the tax base is lower than the carrying amount, the entity will pay a higher income tax in the future). Vice versa, if the carrying amount of assets is lower than their tax base, this results in deductible temporary differences and the recognition of deferred tax assets (as the tax base is higher than the carrying amount, the entity will pay a lower income tax in the future).

Specifically, the following temporary differences appear for the entity's assets (all amounts in CU):

Items	Carrying amount	Tax base	Taxable temporary differences	Deductible temporary differences
Production line	120,000 – (120,000 – 30,000) /10 * 5 = 75,000	120,000 – 120,000/15 * 5 = 80,000		5,000
Equipment	60,000 – 60,000/5*1 – 2,000 = 46,000	60,000 – 60,000/4 = 45,000	1,000	
Land	85,000	80,000	5,000	
Prepaid expenses	5,000	0	5,000	
Inventories	15,000	16,000		1,000
Total	-	-	11,000	6,000

3) CU11,000 are the taxable temporary differences at the end of 20X1 = a deferred tax liability of CU2,200 is needed (CU11,000 * 20%).

The entity has a deferred tax liability at the beginning of the year of CU500, therefore the liability to be recognised in 20X1 amounts to CU1,700. This is partly recognised in equity (revaluation reserve) for the items that are revalued (CU5,000 of revaluation reserve*20% = CU1,000), and the rest (CU700) is recognised in profit or loss.

Therefore, the entity will journalise:

Dr. Deferred tax recognized in equity	1,000	
Cr. Deferred tax liability		1,000

Dr. Deferred tax expense	700	
Cr. Deferred tax liability		700

CU6,000 are the deductible temporary differences at the end of 20X1 = ▯ a deferred tax asset of CU1,200 is needed (CU6,000 * 20%).

The entity has no deferred tax assets recognized at the beginning of 20X1, therefore it must recognise an asset for the full amount of CU1,200.

Dr. Deferred tax asset	1,200	
Cr. Deferred tax income		1,200

The differences between accounting and taxation treatments both impact the statement of financial position and the statement of profit or loss. As such, the entity reports at the end of the year a deferred tax asset of CU1,200 and a deferred tax liability of CU1,700 in the statement of financial position. These represent the amounts of income taxes that are recoverable in future periods, and respectively, the amounts of income taxes that are payable in future periods.

The statement of profit or loss is impacted by a deferred tax expense of CU700 and a deferred tax income of CU1,200. These amounts will determine, together with the current income tax expense, the income tax expense for the period. Moreover, the statement of other comprehensive income is impacted since the entity revalued its land. The revaluation reserve will be reported at CU4,000 (CU5,000 increase resulting from the revaluation minus CU1,000 the deferred tax recognized in equity).