IAS 12 Income Taxes - A Closer Look

Muthupandian, K S

The Institute of Cost and Works Accountants of India

20 December 2008

IAS 12,
Income Taxes
– A Closer Look

K.S.Muthupandian*

International Accounting Standard (IAS) 12, *Income Taxes,* prescribes the accounting treatment for income taxes. In April 1978, the International Accounting Standards Committee (IASC) issued the Exposure Draft E13, *Accounting for Taxes on Income*. In July 1979, the IASC issued IAS 12, *Accounting for Taxes on Income.* In January 1989, the IASC issued Exposure Draft E33, *Accounting for Taxes on Income*. In 1994, the IASC reformatted the IAS 12 (1979). In October 1994, the IASC issued the Modified and Re-exposed Exposure Draft E49, *Income Taxes*. In October 1996, the IASC issued revised IAS 12, *Income Taxes*, which superseded IAS 12 (reformatted 1994). The revised IAS 12 (1996), *Income Taxes* became effective for financial statements covering periods beginning on or after January 1, 1998. In May 1999, IAS 10 (revised 1999), *Events after the balance sheet date*, amended paragraph 88 of IAS 12, effective January 1, 2000. In April 2000, paragraphs 20, 62(a), 64 and Appendix A, paragraphs A10, A11 and B8 of IAS 12 were amended to revise cross-references and terminology as a result of the issuance of IAS 40, *Investment Property*. In October 2000, the IASC issued limited Revisions to IAS 12 (added paragraphs 52A, 52B, 65A, 81(i), 82A, 87A, 87B, 87C and 91 and deleted paragraphs 3 and 50) which operative for periods beginning on or after 1 January 2001. The limited revisions specify the accounting treatment for income tax consequences of dividends. Income taxes are also the subject of a short-term project currently under way by the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB), aimed at reducing the differences between the International Financial Reporting Standards (IFRS) and US Statements of Financial Accounting Standards (SFAS).

***M.Com., AICWA and Member of Tamil Nadu State Treasuries and Accounts Service, presently working as Treasury Officer, Ramanathapuram District, Tamil Nadu. Email: ksmuthupandian@ymail.com**

Objective

The objective of IAS 12 is to prescribe the accounting treatment for income taxes being the accounting for the current and future tax consequences of:

• the future recovery (settlement) of the carrying amount of assets (liabilities) that are recognised in an entity's balance sheet
• transactions and other events of the current period that are recognised in an entity's financial report
• the recognition of deferred tax assets arising from unused tax losses or unused tax credits, the presentation of income taxes and the disclosure of information relating to income taxes are also outlined
• the recognition of deferred tax liabilities arising from taxable temporary differences.

Scope and Application

IAS 12 deals with:

a) Current tax consequences of transactions and other events that give rise to current tax assets and liabilities, and
b) Future tax consequences of transactions and other events that give rise to deferred tax assets and liabilities.

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 venture on distributions to the reporting entity.

Key Definitions

Current tax is the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period.

Deferred tax assets are the amounts of income taxes recoverable in future periods in respect of:

• deductible temporary differences
• the carry forward of unused tax losses
• the carry forward of unused tax credits.

Deferred tax liabilities are the amounts of income taxes payable in future periods in respect of taxable temporary differences.

Tax base of an asset or liability is the amount attributed to that asset or liability for tax purposes.

Tax expense (tax income) is the aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax.

Temporary difference is a difference between the carrying amount of an asset or liability in the balance sheet and its tax base.

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

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

Prescribed Accounting Treatment

IAS 12 requires the recognition of current and deferred tax in an entity's financial report. Current tax for current and prior periods shall, to the extent unpaid, be recognised as a liability. If the amount paid exceeds the amount due for the various periods, the excess shall be recognised as an asset.

Recognition of Current Tax

Current tax for the current and prior periods should be recognised as a liability to the extent that it has not yet been settled, and as an asset to the extent that the amounts already paid exceed the amount due. The benefit of a tax loss which can be carried back to recover current tax of a prior period should be recognised as an asset. Current tax assets and liabilities for the present and prior periods should be measured at the amount expected to be paid to (recovered from) the taxation authorities, using the tax rates (and tax laws) that have been enacted or substantively enacted by the reporting date. A corresponding amount is recognised as an expense or income in the income statement for the period.

It is inherent in the recognition of an asset or liability that the reporting entity expects to recover or settle the carrying amount of that asset or liability. If it is probable that recovery or settlement of that carrying amount will make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences, IAS 12 requires an entity to recognise a deferred tax liability (deferred tax asset), with certain limited exceptions.

Recognition of Deferred Tax Assets

A deferred tax asset should be recognised when there is a deductible temporary difference between the tax base of an asset or liability and its carrying amount in the balance sheet.

A deductible temporary difference arises when the carrying amount of a liability exceeds its tax base, as the future settlement of its carrying amount will be deductible (e.g. provision for warranty is recognised in the accounts at the point of sale but it is only recognised as a tax deduction when the expense is incurred and paid). Further, a deductible temporary difference arises when the carrying amount of an asset is less than its tax base, as its future recovery will generate a tax deduction (e.g. a depreciable asset where accumulated depreciation is greater for accounting than tax purposes, or an asset is revalued downwards but the unrealised loss is not tax deductible until the loss is crystallised by disposal).

A deferred tax asset should be recognised for deductible temporary differences, unused tax losses and unused tax credits to the extent that it is probable that taxable profit will be available against which the deductible temporary differences can be utilised, unless the deferred tax asset arises from:

• negative goodwill which was treated as deferred income under IFRS 3, *Business Combinations*; or

• the initial recognition of an asset/liability other than in a business combination which, at the time of the transaction, does not affect the accounting profit or the taxable profit (tax loss).

Deferred tax assets for deductible temporary differences arising from investments in subsidiaries, associates, branches and joint ventures should be recognised to the extent that it is probable that the temporary difference will reverse in the foreseeable future and that taxable profit will be available against which the temporary difference will be utilised.

The carrying amount of deferred tax assets should be reviewed at the end of each reporting period and reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow the benefit of part or all of that deferred tax asset to be utilised. Any such reduction should be subsequently reversed to the extent that it becomes probable that sufficient taxable profit will be available.

A deferred tax asset should be recognised for an unused tax loss carry forward or unused tax credit if, and only if, it is considered probable that there will be sufficient future taxable profit against which the loss or credit carry forwards can be utilised.

Recognition of Deferred Tax Liabilities

A deferred tax liability should be recognised when there is a taxable temporary difference between the tax base of an asset or liability and its corresponding carrying amount in the balance sheet. This arises when the carrying amount of an asset exceeds its tax base. Consequently, the future recovery of the carrying amount will generate taxable profit.

For example:

- accumulated depreciation of an asset in the financial report is less than the cumulative depreciation allowed up to the reporting date for tax purposes, e.g. depreciation of an asset is accelerated for tax purposes
- development costs have been capitalised and will be amortised to the income statement but were deducted in calculating taxable amounts in the reporting period in which they were incurred.

A taxable temporary difference also arises when the carrying amount of a liability is less than its tax base, because the future settlement of its tax base will generate taxable profit (e.g. a loan initially recognised at fair value net of borrowing costs incurred in the loan establishment but the tax deductions for the costs are amortised over the life of the loan).

The general principle in IAS 12 is that deferred tax liabilities should be recognised for all taxable temporary differences. There are 3 exceptions to the requirement to recognise a deferred tax liability, as follows:

- liabilities arising from the initial recognition of goodwill or goodwill for which amortisation is not deductible for tax purposes;

- liabilities arising from the initial recognition of an asset or liability other than in a business combination which, at the time of the transaction, does not affect either the accounting profit or the taxable profit (tax loss); and

- liabilities arising from undistributed profits from investments where the enterprise is able to control the timing of the reversal of the difference, and it is probable that the reversal will not occur in the foreseeable future.

Measurement of Deferred Tax Assets and Liabilities

Deferred tax assets and liabilities should be measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled (liability method), based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.

An exception arises when the item is credited or charged directly to equity (e.g. the revaluation of property, plant and equipment, or an adjustment to the opening balance of retained earnings due to a change in accounting policy or an error correction), in which case the amount of deferred tax liability or asset is charged or credited directly to equity.

The measurement of deferred tax liabilities and deferred tax assets should reflect the entity's expectations, at the reporting date, as to the manner in which the carrying amount of its assets and liabilities will be recovered or settled.

Deferred tax assets and liabilities should not be discounted.

The carrying amount of a deferred tax asset shall be reviewed at each reporting date. An entity shall reduce the carrying amount of a deferred tax asset to the extent that it is no longer probable that sufficient taxable profit will be available to allow the benefit of part or all of that deferred tax asset to be utilised. Any such reduction shall be reversed to the extent that it becomes probable that sufficient taxable profit will be available.

Recognition of Tax Expense or Income

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

a transaction or event that is recognised directly in equity; or
a business combination accounted for as an acquisition.

If the tax relates to items that are credited or charged directly to equity, the tax should also be charged or credited directly to equity.

If the tax arises from a business combination that is an acquisition, it should be recognised as an identifiable asset or liability at the date of acquisition in accordance with IFRS 3 (thus affecting goodwill or negative goodwill).

Tax Consequences of Dividends

In some jurisdictions, 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. In other jurisdictions, income taxes may be refundable if part or all of the net profit or retained earnings is paid out as a dividend. Possible future dividend distributions or tax refunds should not be anticipated in measuring deferred tax assets and liabilities.

IAS 10, *Events after the Reporting Period*, requires disclosure, and prohibits accrual, of a dividend that is proposed or declared after the end of the reporting period but before the financial statements were authorised for issue. IAS 12 requires disclosure of the tax consequences of such dividends as well as disclosure of the nature and amounts of the potential income tax consequences of dividends.

Presentation

Current tax assets and current tax liabilities should be offset on the balance sheet only if the enterprise has the legal right and the intention to settle on a net basis.

Deferred tax assets and deferred tax liabilities should be offset on the balance sheet only if the enterprise has the legal right to settle on a net basis and they are levied by the same taxing authority on the same entity or different entities that intend to realise the asset and settle the liability at the same time.

Allocation

IAS 12 requires an entity to account for the tax consequences of transactions and other events in the same way that it accounts for the transactions and other events themselves. Thus, for transactions and other events recognised in profit or loss, any related tax effects are also recognised in profit or loss. For transactions and other events recognised directly in equity, any related tax effects are also recognised directly in equity. Similarly, the recognition of deferred tax assets and liabilities in a business combination affects the amount of goodwill arising in that business combination or the amount of any excess of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over the cost of the combination.

Prescribed Disclosures

IAS 12 requires that the major components of tax expense (income) relating to ordinary activities shall be disclosed separately on the face of the statement of comprehensive income. Components of tax expense (income) may include:

(a) current tax expense (income);

(b) any adjustments recognised in the period for current tax of prior periods;

(c) the amount of deferred tax expense (income) relating to the origination and reversal of temporary differences;

(d) the amount of deferred tax expense (income) relating to changes in tax rates or the imposition of new taxes;

(e) the amount of the 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;

(f) the amount of the benefit from a previously unrecognised tax loss, tax credit or temporary difference of a prior period that is used to reduce deferred tax expense;

(g) deferred tax expense arising from the write-down, or reversal of a previous write-down, of a deferred tax asset; and

(h) 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.

Other disclosures include:

• the aggregate current and deferred tax relating to items that are charged or credited to equity

• an explanation of the relationship between tax expense (income) and accounting profit by way of a numerical reconciliation:

(i) between tax expense (income) and the product of accounting profit multiplied by the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed

(ii) between the average effective tax rate and applicable tax rate including the basis which the applicable tax rate is computed

• an explanation of changes in the applicable tax rate compared to the previous reporting period

• 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 balance sheet;
• the aggregate amount of temporary differences associated with investments in subsidiaries, branches and associates and interests in joint ventures, for which deferred tax liabilities have not been recognised;
• in respect of each type of temporary difference, and in respect of each type of unused tax losses and unused tax credits:
(i) the amount of the deferred tax assets and liabilities recognised in the balance sheet for each period presented;
(ii) the amount of the deferred tax income or expense recognised in the income statement, if this is not apparent from the changes in the amounts recognised in the balance sheet;
• in respect of discontinued operations, the tax expense relating to:
(i) the gain or loss on discontinuance; and
(ii) 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.
• 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.

An entity shall disclose the amount of a deferred tax asset and the nature of the evidence supporting its recognition, when:
(a) 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
(b) the entity has suffered a loss in either the current or preceding period in the tax jurisdiction to which the deferred tax asset relates.

In addition to the disclosures required by IAS 12, some disclosures relating to income taxes are required by IAS 1, *Presentation of Financial Statements*, as noted below.

IAS 1 requires disclosures on the face of the statement of financial position about current tax assets, current tax liabilities, deferred tax assets, and deferred tax liabilities.

IAS 1 requires disclosure of tax expense (tax income) on the face of the statement of comprehensive income.

Comparison to Previous Standard

The major changes from the original IAS 12 are as follows.
1. The original IAS 12 required an enterprise to account for deferred tax using either the deferral method or a liability method which is sometimes known as the income statement liability method. IAS 12 (revised) prohibits the deferral method and requires another liability method which is sometimes known as the balance sheet liability method. The income statement liability method focuses on timing differences, whereas the balance sheet liability method focuses on temporary differences.

2. The original IAS 12 permitted an enterprise not to recognise deferred tax assets and liabilities where there was reasonable evidence that timing differences would not reverse for some considerable period ahead. IAS 12 (revised) requires an enterprise to recognise a deferred tax liability or (subject to certain conditions) asset for all temporary differences, with certain exceptions.

3. The original IAS 12 required that:

(a) deferred tax assets arising from timing differences should be recognised when there was a reasonable expectation of realisation; and

(b) deferred tax assets arising from tax losses should be recognised as an asset only where there was assurance beyond any reasonable doubt that future taxable income would be sufficient to allow the benefit of the loss to be realised. The original IAS 12 permitted (but did not require) an enterprise to defer recognition of the benefit of tax losses until the period of realisation. IAS 12 (revised) requires that deferred tax assets should be recognised when it is probable that taxable profits will be available against which the deferred tax asset can be utilised. Where an enterprise has a history of tax losses, the enterprise recognises a deferred tax asset only to the extent that the enterprise has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available.

4. The original IAS 12 required that taxes payable on undistributed profits of subsidiaries and associates should be recognised unless it was reasonable to assume that those profits will not be distributed or that a distribution would not give rise to a tax liability. However, IAS 12 (revised) prohibits the recognition of such deferred tax liabilities (and those arising from any related cumulative translation adjustment) to the extent that:

(a) the parent, investor or venturer is able to control the timing of the reversal of the temporary difference; and

(b) it is probable that the temporary difference will not reverse in the foreseeable future.

Where this prohibition has the result that no deferred tax liabilities have been recognised, IAS 12 (revised) requires an enterprise to disclose the aggregate amount of the temporary differences concerned.

5. The original IAS 12 did not refer explicitly to fair value adjustments made on a business combination. Such adjustments give rise to temporary differences and IAS 12 (revised) requires an enterprise to recognise the resulting deferred tax liability or (subject to the probability criterion for recognition) deferred tax asset with a corresponding effect on the determination of the amount of goodwill or negative goodwill. However, IAS 12 (revised) prohibits the recognition of deferred tax liabilities arising from goodwill itself (if amortisation of the goodwill is not deductible for tax purposes) and of deferred tax assets arising from negative goodwill that is treated as deferred income.

6. The original IAS 12 permitted, but did not require, an enterprise to recognise a deferred tax liability in respect of asset revaluations. IAS 12 (revised) requires an enterprise to recognise a deferred tax liability in respect of asset revaluations.

7. The tax consequences of recovering the carrying amount of certain assets or liabilities may depend on the manner of recovery or settlement, for example:

(a) in certain countries, capital gains are not taxed at the same rate as other taxable income; and

(b) in some countries, the amount that is deducted for tax purposes on sale of an asset is greater than the amount that may be deducted as depreciation.

The original IAS 12 gave no guidance on the measurement of deferred tax assets and liabilities in such cases. IAS 12 (revised) requires that the measurement of deferred tax liabilities and deferred tax assets should be based on the tax consequences that would follow from the manner in which the enterprise expects to recover or settle the carrying amount of its assets and liabilities.

8. The original IAS 12 did not state explicitly whether deferred tax assets and liabilities may be discounted. IAS 12 (revised) prohibits discounting of deferred tax assets and liabilities.

9. The original IAS 12 did not specify whether an enterprise should classify deferred tax balances as current assets and liabilities or as non-current assets and liabilities. IAS 12 (revised) requires that an enterprise which makes the current/non-current distinction should not classify deferred tax assets and liabilities as current assets and liabilities.

10. The original IAS 12 stated that debit and credit balances representing deferred taxes may be offset. IAS 12 (revised) establishes more restrictive conditions on offsetting, based largely on those for financial assets and liabilities in IAS 32, *Financial Instruments: Disclosure and Presentation*.

11. The original IAS 12 required disclosure of an explanation of the relationship between tax expense and accounting profit if not explained by the tax rates effective in the reporting enterprise’s country. IAS 12 (revised) requires this explanation to take either or both of the following forms:

(i) a numerical reconciliation between tax expense (income) and the product of accounting profit multiplied by the applicable tax rate(s); or

(ii) a numerical reconciliation between the average effective tax rate and the applicable tax rate. IAS 12 (revised) also requires an explanation of changes in the applicable tax rate(s) compared to the previous accounting period.

SIC Interpretations

The Standing Interpretation Committee (SIC) of the IASB has issued the following two Interpretations relating to IAS 12:
SIC-21 *Income Taxes – Recovery of Revalued Non-Depreciable Assets* and SIC 25 *Income Taxes – Changes in the Tax Status of an Enterprise or its shareholders.*

IAS 12 notes that the revaluation of an asset does not always affect taxable profit in the period of the revaluation and that the tax base of an asset may not be adjusted as a result of the revaluation. If the future recovery of the carrying amount is taxable, any difference between the carrying amount of the revalued asset and its tax base is a temporary difference and gives rise to a deferred tax liability or asset. SIC 21 addresses the issue of how the term “recovery” is interpreted in relation to an asset that is not depreciated and is revalued in accordance with IAS 16, *Property, Plant and Equipment.* SIC 21 also applies to investment properties that are revalued under IAS 40, *Investment Property,* but would be considered non-depreciable if IAS 16 were applied (e.g. land). The consensus is that as the asset is not depreciated, recovery of the carrying amount will be through sale rather than through use.

SIC 25 addresses the issue of how an entity accounts for the tax consequences of a change in its tax status or that of its shareholders. The consensus is that a change in the tax status of an entity or its shareholders does not give rise to increases or decreases in amounts recognised directly in equity and the current and deferred tax consequences of a change in tax status are included in profit or loss for the period.

The current IASB-FASB convergence project on IAS 12 is likely to also include a review of SIC 21 and SIC 25.

IASB-FASB Convergence Project

The objective of the short term convergence project on Income Taxes is to improve the accounting for income taxes, while reducing the existing differences between IAS 12 and FASB Statement No. 109, *Accounting for Income Taxes.* Although IAS 12 and Statement 109 are based on similar principles, there are certain differences in the application of those similar principles that result in non-comparability of financial information reported internationally. The IASB and the FASB are jointly deliberating the issues in this project.

IAS 12 and Statement 109 are founded on similar principles: both standards take a balance sheet approach to accounting for income taxes. Both standards account for (1) taxes currently payable (or receivable) arising from current taxable income and (2) future (deferred) taxes payable (or receivable) due to differences in U.S. generally accepted accounting principles (GAAP) (or IFRS) and tax bases of assets and liabilities.

But there are some differences in the application of the standards. In addition, IFRS tax accounting differs on stock-based compensation, inter-company transfers and the way deferred taxes are recorded. Such disparities will have to be reconciled—and it remains to be seen whether the U.S. or international interpretation will prevail. Differences between U.S. GAAP and IFRS principally arise for the following reasons:

1. Differences in the exceptions to the application of those similar principles
2. Certain narrow differences in the recognition, measurement, and disclosure criteria in the two standards
3. Differences resulting from some specific application and implementation guidance related to Statement 109.

Both Statement 109 and IAS 12 make certain explicit exceptions to the basic principle, and those exceptions are the primary source of the divergence between the two standards. Statement 109 has six explicit exceptions to the basic principle and IAS 12 has three explicit exceptions to the basic principle. There is some overlap in the exceptions in both standards. Exceptions in either standard may involve country-specific issues (for example, the exception related to U.S. steamship enterprise statutory reserve funds or bad-debt reserves of U.S. savings and loan associations) that do not represent a fundamental difference between the standards.

Additionally, there are subtle but substantive differences between IAS 12 and Statement 109 related to the recognition and measurement of tax assets and liabilities that may create differences in the application of the standards. These differences relate to tax rates (for example, distributed versus undistributed, and enacted versus substantively enacted) and deferred tax asset recognition (thresholds for recognition and approach to valuation allowances—for example, impairment versus affirmative judgment).

Finally, as a result of subsequently issued implementation guidance, there are differences between U.S. GAAP and IFRS that are not solely the result of differences between IAS 12 and Statement 109 as originally issued (for example, initial recognition of deferred tax effects in certain asset acquisitions). For these reasons, the FASB identified income taxes as a topic for its short-term convergence project.

On August 12, 2008, the FASB indefinitely suspended deliberations on its project to improve the accounting for income taxes and merge U.S. standards with international ones in this area. As a result, there is no current plan to amend Statement 109. It may revisit the project after its international counterpart, the IASB, further develops its replacement for IAS 12.

The IASB plans to publish a proposed standard on income taxes that would improve IAS 12 and eliminate certain differences between IFRSs and U.S. GAAP. IASB is expected to issue an exposure draft on accounting for income taxes shortly, which would be followed by a comment period likely to last about 120 days, into the second or third quarter of 2009. The IASB's approach to convergence is not to reconsider the underlying approach, but rather to eliminate exceptions to the basic principle.

Comparative Indian Standard

The Accounting Standard issued by the Institute of Chartered Accountants of India (ICAI) comparative to IAS 12 is AS 22, *Accounting for Taxes on Income.* The major differences between these two standards are differences due to level of preparedness. Keeping in view the level of preparedness in India at the time of issuance of Indian Standard, AS 22 was based on the Income Statement Approach. ICAI is revising AS 22 to bring it in line with IAS 12.

Conclusion

IAS 12 is a well established standard deals with both current and deferred taxes. But deferred tax remains difficult and complex area for some companies. Standards related to income taxes may change even after early adopters in the U.S. move to IFRS.

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