

Deferred tax – A Finance Director's guide to avoiding the pitfalls

Understanding deferred tax under IAS 12 Income Taxes

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Executive Summary

Our experience of companies and groups applying International Financial Reporting Standards (IFRS) is that many Finance Directors find the calculation of a deferred tax provision causes significant practical difficulties. This guide summarises the approach to calculating a deferred tax provision and to allocating the deferred tax charge or credit to the various components of the financial statements. The standard on deferred tax, IAS 12 *Income Taxes*, also contains extensive disclosure requirements. This guide sets out the standard's key disclosure requirements and provides examples of the disclosures required by the standard.

There are also sections that cover some of the more complex areas of preparation of a deferred tax computation, for example the calculation of deferred tax in business combinations.

Calculating a deferred tax provision – the basics (Section 1)

IAS 12 requires a mechanistic approach to the calculation of deferred tax. This section looks at the definitions in the standard and explains, through the use of a flowchart how to navigate through the requirements of IAS 12.

Allocating the deferred tax charge or credit (Sections 2)

The second section of this guide summarises the approach to allocating the deferred tax charge or credit for the year to the various components of the financial statements. The deferred tax charge or credit for the year can arise from a number of sources and therefore may need to be allocated to:

- continuing operations within profit or loss
- discontinued operations within profit or loss
- other comprehensive income
- equity
- goodwill.

Disclosures (Section 3)

IAS 12 contains a number of disclosure requirements. In this section these disclosures are listed and examples of the ways in which these disclosure requirements can be met are given.

These disclosures include:

- details of the components of the current and deferred tax charge
- a reconciliation of the total tax charge to the profit multiplied by the applicable tax rate
- details of the temporary differences forming the deferred tax asset or liability
- details of any unprovided deferred tax.

Avoiding pitfalls – the manner of recovery and the blended rate (Section 4)

Some assets or liabilities can have different tax effects if they are recovered or settled in different ways. For example, the sale of an investment property can give rise to a tax deduction, whereas the use of that investment property might not give rise to a tax deduction.

The calculation of the deferred tax provision should take into account the manner in which management expects to recover or settle an asset or liability. In many cases this may be obvious, in others it may not, and in others the manner of recovery will be a mix of both use and sale. This section looks at the practical problems associated with calculating the impact on the deferred tax provision based on the expected manner of recovery or settlement of an asset or liability.

Avoiding pitfalls – business combinations and consolidated accounts (Section 5)

Business combinations offer an added level of complexity to the reporting of deferred taxes. This section considers a number of practical issues that can arise, specifically:

- whether deferred tax should be recognised on intangible assets acquired in a business combination
- where deferred tax arises on assets acquired in a business combination, whether the tax rate to be applied is that of the acquiree or acquirer
- where deferred tax is recognised in a business combination, whether this leads to an immediate impairment of goodwill
- the provision of deferred tax on unrealised intra-group profits eliminated on consolidation.

Avoiding pitfalls – share-based payments (Section 6)

This section looks at two particular issues that arise in accounting for deferred tax arising on share-based payments, specifically:

- how to calculate the amount to be recognised in equity and the amount to be recognised in profit or loss
- how to account for deferred tax on share-based payments not caught by the measurement provisions of IFRS 2.

Avoiding pitfalls – recognition of deferred tax assets (Section 7)

The recognition of deferred tax assets is subject to specific requirements in IAS 12. These require a deferred tax asset to be recognised to the extent that it is probable that the deferred tax asset will be recovered. This section covers:

- the recoverability of deferred tax assets where taxable temporary differences are available
- the length of lookout periods for assessing the recoverability of deferred tax assets
- the measurement of deferred tax assets in interim financial statements.

Avoiding pitfalls – other issues (Section 8)

This section is a summary of other issues which can arise in practice, namely:

- whether a particular taxation regime meets the definition of an income tax
- the tracking of temporary differences arising on initial recognition
- the accounting for changes in an asset's tax base due to revaluation or indexation of that tax base
- the treatment of deferred tax on gains and losses relating to an available-for-sale financial asset recycled through profit or loss
- accounting for deferred tax on compound financial instruments.

Appendices

Appendix A to this guide provides a Glossary of key terms in IAS 12. Appendix B provides is a guide to the tax legislation in the United Kingdom. It can be used by FDs, or whoever is responsible for calculating the deferred tax provision, to calculate an asset or liability's tax base and hence the necessary deferred tax provision. Appendix B details those aspects of the tax systems that are likely to be relevant most often, it does not detail the entire tax legislation of the UK tax system.

Introduction

Who should read this guide

This guide is intended for Finance Directors (FDs) of businesses that prepare financial statements under International Financial Reporting Standards (IFRS). It illustrates the mechanistic approach that IAS 12 *Income Taxes* applies to the calculation of deferred tax balances. It is not intended to explain every aspect of the standard in detail. Rather, it provides a summary of the approach to calculating the deferred tax provision in order to help FDs to prioritise and identify key issues. Further, the sections on avoiding the pitfalls will help an FD to understand potential problem areas in order to know when to consult further.

Ethical considerations and disclaimer

This guide is intended to provide sufficient background to both the requirements of IAS 12 and UK tax legislation to enable FDs to produce a first credible attempt at a deferred tax provision. The provision of a credible deferred tax provision is important as Ethical Standards in the UK prohibit auditors from calculating deferred tax provisions for their clients.

The use of this guide requires a working knowledge of IFRS and in particular IAS 12. This publication has been prepared only as a guide. No responsibility can be accepted by us for loss occasioned to any person acting or refraining from acting as a result of any material in this publication.

Terminology used in this guide

The terminology used in this guide is consistent with that in IAS 1 *Presentation of Financial Statements* (Revised 2007). This standard is mandatory for annual periods commencing on or after 1 January 2009. Key terminology changes include replacing the term 'balance sheet' with 'statement of financial position' and introducing the statement of comprehensive income (though the new terms are not mandatory). The latter may be presented as one statement or as two, an income statement and a separate statement of comprehensive income, broadly equivalent to the statement of recognised income and expense under the previous version of IAS 1.

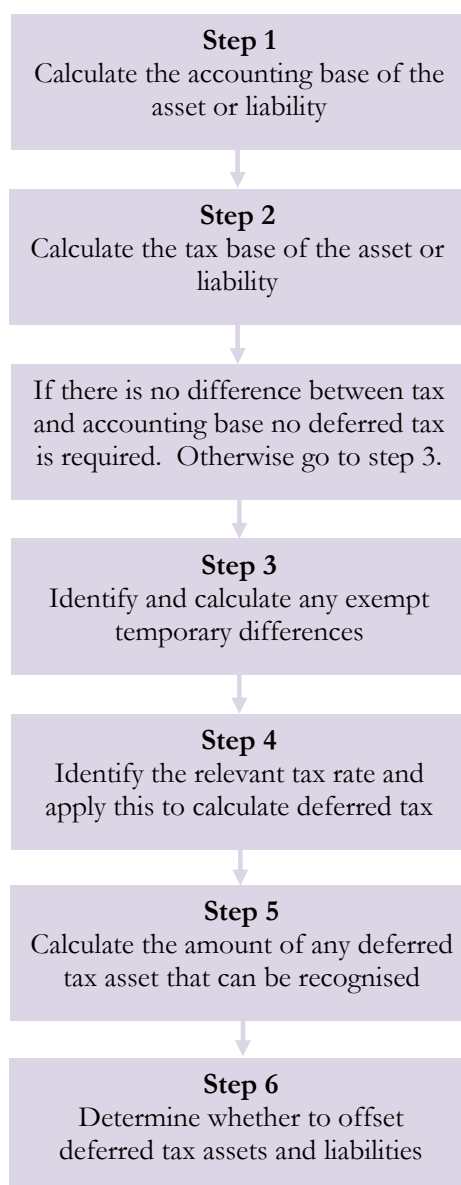
Income and expenses recognised outside profit or loss (ie outside the income statement) are now referred to as being recognised in other comprehensive income.

1 Calculating a deferred tax provision – the basics

Summary of approach

IAS 12 requires a mechanistic approach to the calculation of deferred tax. This section looks at the definitions on the standard and explains, through the use of a flowchart how to navigate through the requirements of IAS 12.

The following flowchart summarises the steps necessary in calculating a deferred tax provision in accordance with IAS 12.



Step 1

Calculate the accounting base of the asset or liability

1.1 What is the accounting base?

The accounting base of an asset or liability is simply the carrying amount of that asset or liability in the statement of financial position. In most cases, the accounting base of an asset or liability is straightforward; however IAS 12 requires the calculation of deferred tax to take into account the expected manner of recovery or settlement of assets and liabilities.

In some cases it might be necessary to consider splitting the carrying value of an asset or liability between an amount to be recovered through use and an amount to be recovered through sale. Section 4 contains a further discussion of assets and liabilities whose carrying amount is recovered through use and sale.

Step 2

Calculate the tax base of the asset or liability

1.2 What is a tax base?**What is the tax base of an asset?**

The tax base of an asset is defined as "...the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset. If those economic benefits will not be taxable, the tax base of the asset is equal to its carrying amount" (IAS 12.7).

What is the tax base of a liability?

The tax base of a liability is defined as "...its carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods. In the case of revenue which is received in advance, the tax base of the resulting liability is its carrying amount, less any amount of the revenue that will not be taxable in future periods" (IAS 12.8).

Appendix B contains further details on the tax legislation extant in the United Kingdom and how that legislation influences the calculation of the tax base of assets and liabilities.

Example 1**Example 1a – the tax base of an asset**

Company A purchased an item of property, plant and equipment for £10,000. Over the life of the asset, deductions of £10,000 will be available in calculating taxable profit through capital allowances. All deductions will be available against trading income and no deductions will be available on sale. Management intend to use the asset.

As deductions of £10,000 will be available over the life of the asset, the tax base of that asset is £10,000.

Example 1b – the tax base of a liability

Company A contributes on behalf of its employees to a defined contribution pension scheme. At the end of the year an accrual for contributions for the year of £5,000 has been made. The UK tax authorities tax payments to defined contribution pension plans on a cash basis.

As the payment of £5,000 to the pension scheme will be allowed as a deduction when the cash is paid, the amount that will be allowed as a deduction in the future is £5,000. Therefore the tax base of the pension accrual is nil, ie carrying amount £5,000 less amount deductible for tax purposes in the future of £5,000.

Tax base of a revalued asset that is not depreciated

When an asset is revalued and that asset is non-depreciable, the carrying amount of that asset will not be recovered through use. Therefore, in accordance with SIC-21 *Income Taxes-Recovery of Revalued Non-Depreciable Assets*, the tax base and tax rate will be those applicable to the sale of that asset. SIC-21.5 states:

"The deferred tax liability or asset that arises from the revaluation of a non-depreciable asset in accordance with IAS 16.31 shall be measured on the basis of the tax consequences that would follow from recovery of the carrying amount of that asset through sale, regardless of the basis of measuring the carrying amount of that asset. Accordingly, if the tax law specifies a tax rate applicable to the taxable amount derived from the sale of an asset that differs from the tax rate applicable to the taxable amount derived from using an asset, the former rate is applied in measuring the deferred tax liability or asset related to a non-depreciable asset."

Items with a tax base but no accounting base

Some items have a tax base but no accounting base, for example carried-forward tax losses and share options. Deferred tax on such items is calculated in the same way as items with an accounting base.

Example 2 – an item with a tax base but no accounting base

Company A issues 100,000 share options to its employees. The options vest immediately. A charge is recognised in profit or loss of £100,000. A tax deduction will be available when those options are exercised, based on the intrinsic value of those share options at the date of exercise.

As a tax deduction will be available in the future when those options are exercised, a tax base exists, even though no asset is recognised in the statement of financial position for the options issued.

Step 3
Identify and
calculate and
exempt
temporary
differences

1.3 What is a temporary difference?

A temporary difference arises whenever the accounting base and tax base of an asset or liability are different. A temporary difference can be either a taxable or deductible temporary difference.

A taxable temporary difference is described in IAS 12.5 as:

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

A deductible temporary difference is described in IAS 12.5 as:

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

Example 3**Example 3a – a taxable temporary difference**

Company A holds an item of property, plant and equipment which has a carrying value of £7,000 and a tax base of £4,000 at the reporting date. There is therefore a temporary difference of £3,000. As the carrying value of the asset is higher than the deductions that will be available in the future, this is a taxable temporary difference.

Example 3b – a deductible temporary difference

Company A contributed to a defined contribution pension scheme. At the year end Company A has recognised an accrual of £5,000. As contributions to the scheme are taxed on a cash basis, the tax base of this liability is nil and there is a temporary difference of £5,000. As a tax deduction will be available in the future when these contributions are paid to the scheme, this is a deductible temporary difference.

Exempt temporary differences

IAS 12 prohibits the recognition of deferred tax on certain temporary differences. The following explains which temporary differences are exempt under the standard:

Taxable temporary differences

A deferred tax liability shall be recognised for all taxable temporary differences. However, IAS 12.15 prohibits the recognition of deferred tax on taxable temporary differences that arise from:

- the initial recognition of goodwill, or
- the initial recognition of 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 (tax loss).

Example 4 – exempt taxable temporary differences**Example 4a – goodwill**

Company A purchases subsidiary B. Goodwill of £150,000 arises on the acquisition. No tax deduction is available in the future for this goodwill because it only arises in the consolidated financial statements. There is therefore a taxable temporary difference of £150,000. However, in accordance with the initial recognition exemption in IAS 12.15 deferred tax is not recognised on that taxable temporary difference.

Example 4b – initial recognition of an asset

Company A purchases an item of property, plant and equipment for £200,000. No tax deduction is available for this asset either through its use or on its eventual disposal. There is therefore a taxable temporary difference of £200,000 on initial recognition of the asset. Assuming that the asset was not purchased in a business combination, the resulting deferred tax liability would not be recognised in accordance with IAS 12.15.

Example 4c – impact of temporary differences arising in a business combination

If the asset above had been recognised in the consolidated financial statements as a result of a business combination, deferred tax would be recognised on the resulting taxable temporary difference. The effect of this would be to increase goodwill by an equal amount.

Deductible temporary differences

A deferred tax asset shall be recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised. However, IAS 12.24 prohibits the recognition of a deferred tax asset if that asset arises from the initial recognition of an asset or liability in a transaction that:

- is not a business combination, and
- at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

Example 5 – exempt deductible temporary difference

Company A purchases an item of property, plant and equipment for £100,000. Tax deductions of £150,000 will be available for that asset. There is therefore a deductible temporary difference of £50,000. As this temporary difference arose on the initial recognition of an asset, and it was not acquired as part of a business combination, no deferred tax should be recognised for this deductible temporary difference.

Tracking exempt temporary differences

As explained above, IAS 12 prohibits the recognition of deferred tax on temporary differences in certain situations, for example on temporary differences that arise on the initial recognition of goodwill. IAS 12 prohibits the recognition of deferred tax on such temporary differences both on the initial recognition of such an item and subsequently (IAS 12.22(c)).

Example 6 – tracking exempt temporary differences**Example 6a – temporary difference arose on initial recognition**

In Example 4a above, a taxable temporary difference of £150,000 arose on the initial recognition of goodwill. As this arose on the initial recognition of the goodwill, no deferred tax was recognised. At the end of the first year after acquisition, impairment of £75,000 has been charged against this goodwill.

The carrying value of this goodwill is therefore £75,000; the tax base is still nil. Therefore, at the year end there is a taxable temporary difference of only £75,000. However, this difference is the unwinding of the initial temporary difference and in accordance with IAS 12 no deferred tax is recognised on this temporary difference either on initial recognition of the asset or subsequently.

Example 6b – temporary difference arose after initial recognition

Company A purchases the trade and assets of company C. Goodwill of £250,000 arises on the acquisition. Tax deductions of £250,000 are available in the future for this goodwill because it arises in the individual company accounts of A. At initial recognition, there is therefore no temporary difference.

At the end of the year, no impairment has been charged on this goodwill. In the tax computation for the year, a deduction of £5,000 has been assumed. The tax base of the goodwill is therefore £245,000 (£250,000 – £5,000). There is therefore a taxable temporary difference of £5,000 relating to this goodwill.

As this temporary difference did not arise on the initial recognition of goodwill, a deferred tax liability must be recognised. The tracking of initial temporary differences is discussed further in Section 8.2.

Exempt temporary differences on investments in subsidiaries, branches and associates, and interests in joint ventures

The standard also includes exemptions for recognising deferred tax on temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures.

IAS 12.39 requires an entity to recognise deferred tax for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, except to the extent that both of the following conditions are satisfied:

- the parent, investor or venturer is able to control the timing of the reversal of the temporary difference, and
- it is probable that the temporary difference will not reverse in the foreseeable future.

IAS 12.44 requires an entity to recognise a deferred tax asset for all deductible temporary differences arising from investments in subsidiaries, branches and associates, and interests in joint ventures, to the extent that, and only to the extent that, it is probable that:

- the temporary difference will reverse in the foreseeable future, and
- taxable profit will be available against which the temporary difference can be utilised.

Example 7 – temporary differences on investments in subsidiaries, branches and associates, and interests in joint ventures**Example 7a – Taxable temporary difference on investment in subsidiary**

Company A purchased Company B on 1 January 20X1 for £300,000. By 31 December 20X1 Company B had made profits, which remained undistributed, of £50,000. No impairment of the goodwill that arose on the acquisition had taken place. The tax base of the investment in Company B is its original cost.

A taxable temporary difference of £50,000 therefore exists between the carrying value of the investment in Company B at the reporting date of £350,000 (£300,000 + £50,000) and its tax base of £300,000. As a parent, by definition, controls a subsidiary it will be able to control the reversal of this temporary difference, for example through control of the dividend policy of the subsidiary. Therefore deferred tax on such temporary differences is generally not provided unless it is probable that the temporary difference will reverse in the foreseeable future.

Example 7b – Taxable temporary difference on investment in an associate

Company A purchases an interest in Associate C on 1 January 20X2 for £450,000. By 31 December 20X2 Associate C had made profits, which remained undistributed, of £75,000 related to this investment. No impairment of the investment in Associate C was required at 31 December 20X2. The tax base of the investment in Associate C is its original cost.

A taxable temporary difference of £75,000 therefore exists between the carrying value of the investment in Company B at the reporting date of £525,000 (£450,000 + £75,000) and its tax base of £450,000. As Company A does not control Associate C it is not in a position to control the dividend policy of Associate C. As a result, it cannot control the reversal of this temporary difference and deferred tax is usually provided on temporary differences arising on investments in associates.

Step 4

Identify the relevant tax rate and apply this to calculate deferred tax

1.4 Calculation of deferred tax – identification of the appropriate tax rate

IAS 12 requires deferred tax assets and liabilities to be measured at the tax rates that are expected to apply to the period in which the asset is realised or the liability is settled, based on tax rates that have been enacted or substantively enacted by the end of the reporting period.

In the UK substantive enactment is considered to occur when the relevant tax Bill proposing the change has had its third reading in the House of Commons.

As the rate to be used is that applicable to the period in which the temporary difference is expected to reverse, some scheduling of the realisation of deferred tax assets and liabilities might be required.

Example 8

Company A is preparing its financial statements for the year ended 30 June 20X1. Company A intends to sell an item of property, plant and equipment which has an associated taxable temporary difference of £100,000. The tax rate applicable to Company A for the year ended 30 June 20X1 is 30%. Company A expects to sell the property, plant and equipment in 20X2. The Finance Bill had its third reading in the House of Commons on 18 June 20X1 and proposes a new corporation tax rate of 28% to apply from 1 April 20X2.

As the new Bill has had its third reading in the House of Commons by the reporting date the tax legislation contained therein is considered to be substantively enacted. Therefore if Company A expects to sell the asset before the new tax rate become effective, a rate of 30% should be used to calculate the deferred tax liability associated with this item of property, plant and equipment. Alternatively, if Company A does not expect to sell the asset until after 1 April 20X2, the appropriate tax rate to use is 28%.

Step 5

Calculate the amount of any deferred tax asset that can be recognised

1.5 Recognition of deferred tax assets

For a deferred tax asset, there must be an expectation of sufficient future taxable profits to utilise the deductible temporary differences. Economic benefits in the form of reductions in tax payments will flow to the entity only if it earns sufficient taxable profits against which the deductions can be offset. Therefore, an entity recognises deferred tax assets only when it is probable that taxable profits will be available against which the deductible temporary differences can be utilised.

IAS 12.28-31 contain guidance on when sufficient taxable profits are expected to arise. IAS 12.28 states that it is probable that taxable profit will be available against which a deductible temporary difference can be utilised when there are sufficient taxable temporary differences relating to the same taxation authority and the same taxable entity which are expected to reverse:

- in the same period as the expected reversal of the deductible temporary difference, or
- in periods into which a tax loss arising from the deferred tax asset can be carried back or forward.

When there are insufficient taxable temporary differences relating to the same taxation authority and the same taxable entity, a deferred tax asset is recognised to the extent that:

- it is probable that the entity will have sufficient taxable profit relating to the same taxation authority and the same taxable entity in the same period as the reversal of the deductible temporary difference, or in the periods into which a tax loss arising from the deferred tax asset can be carried back or forward; or
- tax planning opportunities are available to the entity that will create taxable profit in appropriate periods.

Management will need to use their judgement in estimating whether there will be sufficient taxable profits in the future to recognise a deferred tax asset. Management will also need to make estimates about the expected timing or reversal of the deductible and taxable temporary differences when considering whether a deferred tax asset can be recognised.

Example 9

Example 9a – timing of reversal

At 31 December 20X1, Company A has deductible temporary differences of £45,000 which are expected to reverse in the next year. Company A also has taxable temporary differences of £50,000 relating to the same taxable entity and the same tax authority. Company A expects £30,000 of those taxable temporary differences to reverse in the next year and the remaining £20,000 to reverse in the year after.

Company A must therefore recognise a deferred tax liability for the £50,000 taxable temporary differences. Separately, as £30,000 of these taxable temporary differences are expected to reverse in the year in which the deductible temporary differences reverse, Company A can also recognise a deferred tax asset for £30,000 of the deductible temporary. Whether a deferred tax asset can be recognised for the rest of the deductible temporary differences will depend on whether future taxable profits sufficient to cover the reversal of this deductible temporary difference are expected to arise.

At present both the deferred tax liability and the deferred tax asset must be recognised. Whether this deferred tax asset and deferred tax liability can be offset is considered in the step 1.6.

Example 9b – different types of tax losses

Company A has an item of property, plant and equipment which is expected to be sold. When this asset is sold, a capital tax loss of £50,000 will crystallise, ie there is an associated deductible temporary difference of this amount. Company A also has taxable temporary differences of £75,000 associated with its trade expected to reverse in the same period as the deductible temporary difference.

The UK tax authorities do not allow the offset of capital losses against trading profits. Therefore, in considering whether the deferred tax asset associated with the item of property, plant and equipment can be recognised, the taxable temporary differences associated with Company A's trade must be ignored. Hence, in the absence of other information, a deferred tax liability must be recognised for the £75,000 of taxable temporary differences and no deferred tax asset can be recognised for the deductible temporary difference.

Unused tax losses and unused tax credits

The general principle in IAS 12 is that a deferred tax asset is recognised for unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised.

The criteria for the recognition of deferred tax assets for unused tax losses and unused tax credits are the same as those arising from deductible temporary differences. However, the standard also notes that the existence of unused tax losses is strong evidence that future taxable profit may not be available. As a result, the standard requires that where an entity has a history of recent losses, the entity recognises a deferred tax asset arising from unused tax losses or tax credits only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilised by the entity.

Example 10

At 31 December 20X1, Company A has unused tax losses of £75,000 and taxable temporary differences of £25,000 relating to the same taxation authority. Company A has been loss making for the last two years.

In the absence of convincing evidence that there will be sufficient taxable profits against which the deductible temporary differences can be realised, a deferred tax asset is only recognised to the extent of the taxable temporary differences. Therefore a deferred tax asset is recognised for £25,000 of the unused tax losses and a deferred tax liability is recognised for the £25,000 taxable temporary differences.

The next step considers whether the resulting deferred tax asset and deferred tax liability should be offset in the statement of financial position.

There is further guidance in Section 7 on assessing whether the recovery of deferred tax assets is probable.

Step 6
Determine whether to offset deferred tax assets and liabilities

1.6 Offsetting of deferred tax assets and liabilities

Deferred tax assets and liabilities can be offset only in certain restricted scenarios. Deferred tax assets and liabilities must be recognised gross in the statement of financial position unless:

- the entity has a legally enforceable right to set off current tax assets against current tax liabilities, and
- the deferred tax assets and the deferred tax liabilities relate to income taxes levied by the same taxation authority on either:
 - the same taxable entity, or
 - different taxable entities which intend either to settle current tax liabilities and assets on a net basis, or to realise the assets and settle the liabilities simultaneously, in each future period in which significant amounts of deferred tax liabilities or assets are expected to be settled or recovered.

Example 11

Example 11a – deferred tax asset and liability in the same company

Company A has a recognised deferred tax asset of £30,000 and a recognised deferred tax liability of £65,000, both relating to income taxes levied by the same taxation authority. Company A has a right to set off its current tax assets against its current tax liabilities.

Company A should recognise a net deferred tax liability of £35,000, as the entity has a legally enforceable right to offset current tax assets and liabilities and the deferred tax asset and liability relate to income taxes levied by the same taxation authority on the same taxable entity.

Example 11b – deferred tax asset and liability in different companies in the same group

Company A has a recognised deferred tax asset of £30,000. Company A has a subsidiary Company B with a recognised deferred tax liability of £65,000. Company A also has a legally enforceable right to offset current tax assets and liabilities. The recognised deferred tax asset and deferred tax liability both relate to the same taxation authority.

As the deferred tax asset and liability do not relate to the same taxable entity, management must consider whether these taxable entities either intend to settle current tax liabilities and assets on a net basis or to realise the assets and settle the liabilities simultaneously. This will generally not be the case unless Company A and Company B are part of a tax group.

2 Allocating the deferred tax charge or credit

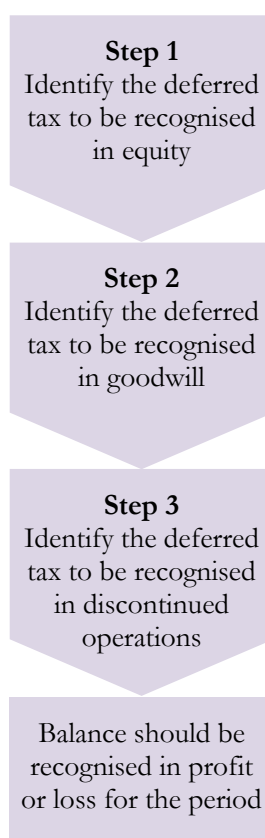
Allocating the deferred tax charge or credit

The second section of this guide summarises the approach to allocating the deferred tax charge or credit for the year to the various components of the financial statements. The deferred tax charge or credit for the year can arise from a number of sources and therefore may need to be allocated to:

- continuing operations within profit or loss
- discontinued operations within profit or loss
- other comprehensive income
- equity
- goodwill.

Flowchart for allocating the deferred tax charge or credit

The following flowchart summarises the steps necessary in allocating the deferred tax charge or credit to the various components of the financial statements.



Step 1
Identify the deferred tax to be recognised in equity

2.1 Recognition of deferred tax in equity

Generally, under IAS 12, deferred tax is charged or credited in profit or loss. IAS 12.58 requires that current and deferred tax shall be recognised as income or an expense and included in profit or loss for the period, except to the extent that the tax arises from:

- a transaction or event which is recognised, in the same or a different period, outside profit or loss, either in other comprehensive income or directly in equity; or
- a business combination.

The rest of this step considers the first of these bullets, ie when a transaction has affected equity. If there has been no recognition of any gains or losses outside of the profit or loss, either in current or prior periods, and there are no equity-settled share-based payments, this step can be ignored.

When to recognise deferred tax directly in equity

IAS 12.61A requires, where deferred tax arises on items charged or credited directly to equity, the associated deferred tax to be charged or credited directly to equity. IAS 12.61A further analyses these items into those recognised in other comprehensive income and those recognised directly in equity.

Recognised in other comprehensive income

Examples of items which are recognised in other comprehensive income include:

- actuarial gains and losses on defined benefit pension schemes where the option in IAS 19 *Employee Benefits* to recognise these in other comprehensive income has been taken
- fair value adjustments on available-for-sale financial assets
- movements on hedging relationships taken directly to equity
- revaluations of property, plant and equipment.

Example 12

On 1 January 20X1 Company A purchases an equity investment for £6,000. This financial asset is classified, in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*, as an available-for-sale financial asset. At 31 December 20X1, this financial asset has a fair value of £8,500. The gain on revaluation of this financial asset is taken to other comprehensive income in accordance with IAS 39. The financial asset has a tax base of its original cost.

The taxable temporary difference of £2,500 that arises due to the revaluation gives rise to a deferred tax charge in the year of £700, at a tax rate of 28%. The resulting deferred tax charge should be recognised in other comprehensive income to match the recognition of the gain that gave rise to this deferred tax charge.

Recognised directly in equity

Examples of items that are recognised directly in equity include:

- an adjustment to the opening balance of retained earnings resulting from either a change in accounting policy that is applied retrospectively or the correction of an error, and
- amounts arising on initial recognition of the equity component of a compound financial instrument.

Deferred tax on equity-settled share-based payments

IAS 12 also contains specific rules on the deferred tax that can arise on equity-settled share-based payments accounted for under IFRS 2 *Share-based Payment*. In certain tax jurisdictions, including the UK, a tax deduction is available when share options are exercised. The tax deduction is based on the intrinsic value of those options at the date of exercise.

The rules in IAS 12.68A-68C cover two main complications that arise with such tax deductions:

- how the tax deduction should be measured at the end of the period, and
- where the resulting deferred tax should be recognised.

Measurement of deferred tax

IAS 12.68B requires the tax deduction expected to be available to be based on the entity's share price at the end of the reporting period.

Component in which to recognise deferred tax

IAS 12.68C requires the deferred tax credit that arises to be recognised in profit or loss unless the tax deduction that is expected to be available exceeds the cumulative remuneration charge recognised to date. Where the expected future tax deduction is greater than the cumulative share-based payment expense recognised, the deferred tax credit relating to that excess is recognised directly in equity.

Example 13

On 1 January 20X1, Company A issued share options to its employees with a one year vesting period. At 31 December 20X1, an IFRS 2 charge of £15,000 had been recognised. At 31 December 20X1, the share options expected to be exercised had a total intrinsic value of £25,000. In the year, a deferred tax credit of £7,000 should be recognised, based on a tax rate of 28% (£25,000 × 28%).

At 31 December 20X1, the expected tax deduction of £25,000 exceeds the cumulative IFRS 2 charge recognised to date of £15,000 by £10,000. Therefore, of the tax credit of £7,000, £4,200 should be recognised in profit or loss (£15,000 × 28%) and £2,800 should be recognised directly in equity (£10,000 × 28%).

A more extensive example of the deferred tax associated with equity-settled share-based payments is considered in Section 6.

Step 2

Identify the deferred tax to be recognised in goodwill

2.2 Deferred tax allocated to business combinations

Where a deferred tax asset or liability arises on a business combination, a calculation of that deferred tax asset or liability is required at the date of acquisition. The deferred tax asset or liability so arising affects goodwill at the date of the acquisition, in accordance with IAS 12.66, and not profit or loss.

The calculation of goodwill on a business combination in accordance with IFRS 3 *Business Combinations* requires a comparison of the fair value of the net assets acquired with the fair value of the consideration transferred. Any difference is either recognised as goodwill, to the extent the consideration transferred exceeds the fair value of the net assets acquired, or is recognised immediately in profit or loss, to the extent the fair value of the net assets acquired exceeds the consideration transferred.

The deferred tax asset or liability associated with the net assets acquired is calculated in the same way as other deferred tax assets and liabilities, ie it is not fair valued at the date of acquisition. Therefore, if the accounting base of the assets and liabilities acquired is different from their tax base, deferred tax will need to be provided on those temporary differences. The resulting deferred tax assets and liabilities will affect the value of the net assets acquired and hence will impact the calculation of any goodwill, or bargain purchase gain.

Example 14

Example 14a – Temporary differences arising on acquisition

On 6 June 20X1, Company A acquired Company B for £50,000. At the date of acquisition, the fair value of the identifiable assets and liabilities of Company B was £25,000. This included an intangible asset that was not recognised in the separate financial statements of Company B, of £5,000. The tax base of the assets and liabilities acquired, other than the intangible asset, was equal to their accounting base. The tax base of the intangible asset was nil.

Therefore, a taxable temporary difference of £5,000 exists at the date of acquisition, and a deferred tax liability of £1,400 is recognised ($£5,000 \times 28\%$). The net assets at the date of acquisition are therefore £23,600 ($£25,000 - £1,400$) and goodwill of £26,400 ($£50,000 - £23,600$) is recognised.

Example 14b – Movements on temporary differences associated with business combinations

In the previous example a deferred tax liability of £1,400 was recognised at the date of acquisition of Company B. The recognition of this deferred tax liability caused the carrying value of goodwill to increase by an equivalent amount at the date of acquisition.

At 31 December 20X1, the intangible asset has been amortised and is now carried in the statement of financial position at £4,200. Hence, the deferred tax liability associated with this intangible asset is £1,176 ($£4,200 \times 28\%$). Assuming the amortisation of this intangible asset is recognised in profit or loss, so the movement in the deferred tax liability of £224 ($£1,400 - £1,176$) is also recognised in profit or loss.

Deferred tax assets of the acquirer

An acquirer might have deferred tax assets that it was not recognising. However, as a result of the business combination, management may judge that the recovery of an existing deferred tax asset is now probable. In such cases, the deferred tax asset is recognised but it should not be included in the net identifiable assets of the acquired business for the purposes of the goodwill calculation. Instead, such a deferred tax asset would be recognised as a gain in the current period.

Deferred tax assets of the acquiree

IFRS 3 was revised in 2008. IFRS 3 (Revised 2008), IFRS 3R, amended the treatment of deferred tax assets of the acquiree not recognised at the date of the business combination. The following paragraphs consider the accounting for such deferred tax assets of the acquiree both before and after amendment of IAS 12. The amendments to IAS 12 are applicable in the first annual financial statements in which IFRS 3R is applied. IFRS 3R is mandatory for accounting periods beginning on or after 1 July 2009.

IFRS 3 before amendment in 2008

If the acquired business has deferred tax assets that are recognised at the date of the combination then, as set out above, their recognition affects the amount of goodwill recognised. If, however, a deferred tax asset is not recognised at the date of acquisition but is recognised subsequently the deferred tax asset is recognised through profit and loss and an adjustment is made to goodwill.

IAS 12.68 requires, in these circumstances, the acquirer to:

- reduce the carrying amount of goodwill to the amount that would have been recognised if the deferred tax asset had been recognised as an identifiable asset from the acquisition date; and
- recognise the reduction in the carrying amount of goodwill as an expense.

Where the adjustment would cause an 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, IAS 12 prohibits recognition of such an excess.

Example 15**Example 15a – Deferred tax asset of acquiree recognised after the date of acquisition**

On 31 July 20X1, Company A acquired Company C. Company C had trading losses available for deduction against future trading profits of £50,000 at the date of acquisition. These losses did not qualify for recognition in accordance with IAS 12 at the date of acquisition. At the date of combination, goodwill of £100,000 was recognised.

On 31 December 20X2, management now consider it probable that future taxable profits will be recognised by Company C sufficient to justify recognition of this deferred tax asset. Therefore a deferred tax asset of £14,000 is recognised ($£50,000 \times 28\%$) with an equivalent credit recognised in tax allocated to profit or loss. Separately goodwill is reduced to £86,000 ($£100,000 - £14,000$); this reduction is not taken through the tax line but is recognised with other expenses. If material, management might consider drawing attention to this charge resulting from the reduction in goodwill either in the notes or on the face of the statement of comprehensive income.

Example 15b – Recognition of deferred tax asset would result in an excess of net assets over the cost of the combination

On 30 August 20X2, Company A acquired Company D. Company D had trading losses available for deduction against future trading profits of £100,000 at the date of acquisition. These losses did not qualify for recognition in accordance with IAS 12 at the date of acquisition. At the date of combination, goodwill of £25,000 was recognised.

On 31 December 20X3, management now consider it probable that future taxable profits will be recognised by Company C sufficient to justify recognition of this deferred tax asset. Therefore a deferred tax asset of £28,000 is recognised ($£100,000 \times 28\%$) with an equivalent credit recognised in the tax line of the statement of comprehensive income.

Separately goodwill is reduced to nil, with a charge of £25,000 recognised in profit or loss. Had this deferred tax asset been recognised at the date of the combination a gain would have been recognised in profit or loss of £3,000 ($£25,000 - £28,000$). However, IAS 12.68 prohibits the recognition of such an excess if the deferred tax asset cannot be recognised at the date of the combination.

IFRS 3 (Revised 2008)

The introduction of IFRS 3R has changed these requirements. IFRS 3R.68 states:

- acquired deferred tax benefits recognised within the measurement period that result from new information about facts and circumstances that existed at the acquisition date shall be applied to reduce the carrying amount of any goodwill related to that acquisition. If the carrying amount of that goodwill is nil, any remaining deferred tax benefits shall be recognised in profit or loss
- all other acquired deferred tax benefits realised shall be recognised in profit or loss (or, if IAS 12 so requires, outside profit or loss).

IFRS 3R contains transitional provisions which require this amendment to be accounted for prospectively. Therefore, assets, liabilities and goodwill recognised in previous business combinations are not adjusted retrospectively. However, where an acquirer's deferred tax asset acquired in a business combination to which IFRS 3R is not applied is subsequently recognised in a period in which IFRS 3R is applied the adjustment to deferred tax is recognised in profit or loss and goodwill is not adjusted.

Example 16

On 31 July 20X1, Company A acquired Company C. Company C had trading losses available for deduction against future trading profits of £50,000 at the date of acquisition. These losses did not qualify for recognition in accordance with IAS 12 at the date of acquisition. At the date of combination, goodwill of £100,000 was recognised.

On 31 December 20X2, management still did not consider it probable that future taxable profits would be recognised by Company C sufficient to justify recognition of this deferred tax asset.

IFRS 3R was applied by Company A for the financial year beginning 1 January 20X3. On 31 December 20X3 management now consider it probable that future taxable profits will be recognised by Company C sufficient to justify recognition of this deferred tax asset. Therefore a deferred tax asset of £14,000 is recognised (£50,000 × 28%) with an equivalent credit recognised in tax allocated to profit or loss. In accordance with the revised provisions of IAS 12 introduced by IFRS 3R no adjustment is made to goodwill.

Step 3

Identify the deferred tax to be recognised in discontinued operations

2.3 Deferred tax allocated to discontinued operations

If there are no discontinued operations then this step can be ignored.

There are no explicit requirements for allocating deferred tax charges or credits between continuing and discontinued operations. However IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* requires a single amount to be shown on the face of the statement of comprehensive income comprising the total of:

- the post-tax profit or loss of discontinued operations, and
- the post-tax gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation.

IFRS 5 also requires this single amount to be disaggregated into the following:

- the revenue, expenses and pre-tax profit or loss of discontinued operations
- the related income tax expense as required by IAS 12.81(h)
- the gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation
- the related income tax expense as required by IAS 12.81(h).

As there is no explicit guidance in IAS 12 on allocating the deferred tax charge or credit between continuing and discontinued operations, management should use their judgement to determine an accounting policy. If material this judgement will need to be disclosed in accordance with IAS 1.122.

2.4 Deferred tax recognised in profit or loss

Having identified the amount of the movement in deferred tax attributable to business combinations, other comprehensive income, other elements of equity and discontinued operations any remaining movement in the net deferred tax asset or liability should be recognised in profit or loss.

Balance should be recognised in profit or loss for the period

3 Disclosures

Disclosures

IAS 12 contains a number of disclosure requirements. In this section these disclosures are listed and examples of the ways in which these disclosure requirements can be met are given.

These disclosures include:

- details of the components of the current and deferred tax charge
- a reconciliation of the total tax charge to the profit multiplied by the applicable tax rate
- details of the temporary differences forming the deferred tax asset or liability
- details of any unprovided deferred tax.

3.1 Disclosures relating to current and deferred tax charge

IAS 12 requires disclosures to support and explain the tax charge. These are detailed below and examples of these disclosures are also included.

IAS 12.79 requires the major components of tax expense (income) to be disclosed separately. The major components of tax expense may include (IAS 12.80):

- current tax expense (income)
- any adjustment recognised in the period for current tax of prior periods
- the amount of deferred tax expense (income) relating to the origination and reversal of temporary differences
- the amount of deferred tax expense (income) relating to changes in tax rates or the imposition of new taxes
- the amount of benefit arising from a previously unrecognised tax loss, tax credit or temporary difference of a prior period that is used to reduce deferred tax expense
- deferred tax expense arising from the write-down, or reversal of a previous write-down, of a deferred tax asset
- 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.

An example of this disclosure is given below:

	20X2		20X1	
	£m	£m	£m	£m
UK Corporation tax				
Current tax on income for the year	6.4		3.4	
Adjustment in respect of prior years	(2.4)		(1.3)	
		4.0		2.1
Overseas tax				
Current tax on income for the year	50.8		42.6	
Adjustment in respect of prior years	0.7		(0.3)	
		51.5		42.3
Total current taxation		55.5		44.4
Deferred taxation				
Original and reversal of temporary differences		4.5		8.4
Effect of changes in tax rates		-		0.2
Total taxation charge		60.0		53.0

IAS 12.81(a) requires disclosure of the aggregate current and deferred tax relating to items that are charged or credited directly to equity and IAS 12.81(ab) requires disclosure of income tax relating to each component of other comprehensive income. An example of these disclosures might be:

	20X2 £m	20X1 £m
Total current and deferred tax recognised in other comprehensive income:		
On gains and losses on available-for-sale financial assets	(1.5)	(1.0)
On actuarial gains and losses	(22.2)	11.7
On foreign currency translation differences	2.2	0.5
	<u>(21.5)</u>	<u>11.2</u>

	20X2 £m	20X1 £m
Total current and deferred tax recognised directly in equity:		
On equity-settled share-based payments	(0.1)	0.2
	<u>(0.1)</u>	<u>0.2</u>

IAS 12.81(c) requires an explanation of the relationship between tax expense (income) and accounting profit in either or both of the following forms:

- a numerical reconciliation between tax expense (income) and the product of accounting profit multiplied by the applicable tax rate(s), disclosing also the basis on which the applicable tax rate(s) is (are) computed, or
- a numerical reconciliation between the average effective tax rate and the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed.

Such a reconciliation might be given in the following form:

	20X2 £m	20X1 £m
Profit before tax	176.0	171.0
Income tax using the Company's domestic rate of tax of 28% (2007: 30%)	49.3	51.3
Effects of:		
Non-taxable and non-deductible items	11.1	1.5
Utilisation of tax losses	(0.2)	(0.4)
Current year losses for which no deferred tax asset has been recognised	3.0	0.4
Change in tax rates	-	0.2
Differing tax rates in different jurisdictions	(0.8)	2.1
Over-provided in prior years	(2.4)	(2.1)
Total taxation charge	60.0	53.0

IAS 12.81 also requires disclosure of:

- an explanation of changes in the applicable tax rate(s) compared to the previous accounting period (IAS 12.81(d))
- 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 statement of financial position (IAS 12.81(e))
- 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 (IAS 12.81(f)).

These disclosures might be given in narrative form as follows:

The standard rate of corporation tax in the UK changed from 30% to 28% with effect from 1 April 20X2. There have also been a number of changes to the tax rate in several overseas jurisdictions.

At 31 December 20X2 the group had unused tax losses amounting to £23 million (20X1: £20 million) for which no deferred tax asset has been recognised. These tax losses are not expected to expire.

At 31 December 20X2 taxable temporary differences associated with investments in subsidiaries for which no deferred tax liability had been recognised totalled £2 million (20X1: £1.5 million).

Discontinued operations

In respect of discontinued operations IAS 12.81(h) requires disclosure of the tax expense relating to:

- the gain or loss on discontinuance
- 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.

These disclosure requirements could be met in narrative form as follows:

The income tax charge for the year relating to the discontinued operations profit for the year was £5.0 million (20X1: £3.0 million). In addition, a further tax charge of £1.5 million arose on the sale of this operation in the current year.

3.2 Disclosures relating to the deferred tax provision

As well as requiring disclosures to support and explain the tax charge, IAS 12 also requires disclosures to support and explain the deferred tax asset or liability. IAS 12.81(g) requires the notes to the financial statements to disclose in respect of each type of temporary difference, and in respect of each type of unused tax losses and unused tax credits:

- the amount of the deferred tax assets and liabilities recognised in the statement of financial position for each period presented
- the amount of the deferred tax income or expense recognised in profit or loss, if this is not apparent from the changes in the amounts recognised in the statement of financial position.

This disclosure could be accomplished as follows:

	Balance at 1 January 20X1	Recognised in continuing operations	Recognised in discontinued operations	Recognised directly in equity	Acquisitions / disposals	Balance at 31 December 20X1
Non-current assets	(17.5)	(3.2)	(3.0)	-	(1.6)	(25.3)
Inventories	2.3	0.6	-	-	-	2.9
Interest-bearing loans and borrowings	0.6	4.0	-	-	-	4.6
Employee benefits (including share-based payments)	29.4	(7.2)	-	26.4	-	48.6
Tax value of losses carried forward	3.6	3.4	-	-	-	7.0
	18.4	(2.4)	(3.0)	26.4	(1.6)	37.8

	Balance at 1 January 20X0	Recognised in continuing operations	Recognised in discontinued operations	Recognised directly in equity	Acquisitions / disposals	Balance at 31 December 20X0
Non-current assets	(18.0)	1.3	-	-	(0.8)	(17.5)
Inventories	1.8	0.8	-	-	(0.3)	2.3
Interest-bearing loans and borrowings	0.2	(0.6)	-	1.0	-	0.6
Employee benefits (including share-based payments)	55.0	(12.6)	-	(12.8)	(0.2)	29.4
Tax value of losses carried forward	1.3	2.1	-	-	0.2	3.6
	40.3	(9.0)	-	(11.8)	(1.1)	18.4

3.3 Other disclosures

In addition to the disclosures set out above, other disclosures are required in certain specific situations. These include:

- 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 (IAS 12.81(i))
- the amount of a deferred tax asset and the nature of the evidence supporting its recognition, when:
 - 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
 - the entity has suffered a loss in either the current or preceding period in the tax jurisdiction to which the deferred tax asset relates (IAS 12.82).

Also, where 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 to shareholders of the entity, which may be particularly relevant to the Real Estate Investment Trust industry, an additional disclosure is required. In these circumstances an entity must disclose the nature of the potential income tax consequences that would result from the payment of dividends to its shareholders. In addition, the entity shall disclose the amounts of the potential income tax consequences practicably determinable and whether there are any potential income tax consequences not practicably determinable (IAS 12.82A).

3.4 Additional disclosure brought in by IFRS 3 (Revised 2008)

As a result of the introduction of IFRS 3 (Revised 2008), see Section 2.2, additional disclosures are required in certain situations. These are:

- if a business combination causes a change in the amount recognised for the acquirer's pre-acquisition deferred tax asset, the amount of that change, and
- if the deferred tax benefits acquired in a business combination are not recognised at the acquisition date but are recognised after the acquisition date, a description of the event or change in circumstances that causes the deferred tax benefits to be recognised.

4 Avoiding pitfalls – the manner of recovery and the blended rate

Avoiding pitfalls – the manner of recovery and the blended rate

Some assets or liabilities can have different tax effects if they are recovered or settled in different ways. For example, the sale of an investment property can give rise to a tax deduction, whereas the use of that investment property might not give rise to a tax deduction.

The calculation of the deferred tax provision should take into account the manner in which management expects to recover or settle an asset or liability. In many cases this may be obvious, in others it may not, and in others the manner of recovery will be a mix of both use and sale. This section looks at the practical problems associated with calculating the impact on the deferred tax provision based on the expected manner of recovery or settlement of an asset or liability.

4.1 Method of recovery of an asset

Many assets are recovered partly through use and partly by sale. For example, it is common for an investor to hold an investment property to earn rentals for a period and then sell it. Other assets, such as property, plant and equipment and intangible assets are also frequently used in a business for part of their economic life and then sold. When such assets are depreciated, the residual value ascribed to them indicates an estimate of the amount expected to be recovered through sale.

Under IAS 12, the measurement of deferred taxes related to an asset should reflect the tax consequences of the manner in which an entity expects to recover the carrying amount of the asset (IAS 12.51-52). When the tax rate and the tax base are the same for both use and sale of the asset, the deferred tax does not depend on the manner of recovery and hence no complications arise. In some jurisdictions the tax rate applicable to benefits generated from using a specific asset, the 'use rate', differs from the rate applicable to benefits from selling the asset, the 'sale rate'. Further, tax bases may vary depending on how an entity benefits from a specific asset, for example as they do in the UK for investment property. In these circumstances, the measurement of deferred taxes should be consistent with the expected manner of recovery of the asset. This principle requires measurement of deferred taxes by reference to:

- the use tax rate and the tax base applicable for the use of the asset to the extent that the entity expects to recover the carrying amount of the asset through use, and
- the sale tax rate and the tax base applicable for the sale of the asset to the extent that the entity expects to recover the carrying amount through sale.

SIC-21 *Income Taxes-Recovery of Revalued Non-depreciable Assets* clarifies this requirement in one context: deferred taxes arising from the revaluation of non-depreciable assets need to be measured on the basis of the tax consequences that would follow from the recovery of the carrying amount through sale (SIC-21.5).

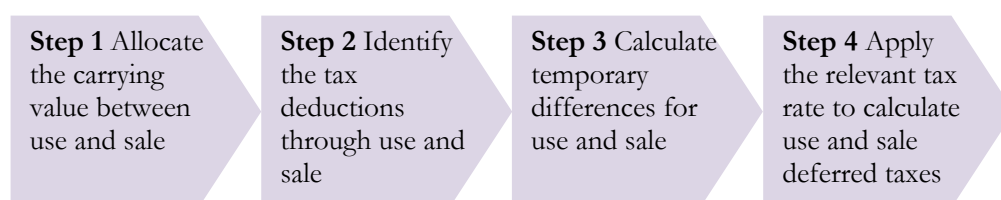
Dual intention assets

The application of IAS 12.52 is also straightforward in situations where an asset will be recovered in its entirety through either use or sale. The measurement of deferred taxes is, however, more complex when an entity has 'dual intentions', ie if it intends to first use and then sell the asset. In this case, a measurement approach needs to be adopted that reflects the tax consequences of this dual intention.

IAS 12 does not set out specific guidance on how to determine deferred taxes for 'dual intention-assets' when different tax rates and/or tax bases apply. One approach used in practice is to calculate temporary differences and measure the resulting deferred taxes using a blended measurement approach.

Methodology for calculating deferred tax on dual intention assets

The procedure for the blended measurement approach can be illustrated as follows:



- Step 1** Determine the element of the carrying value of the asset that will be recovered through use and through sale, respectively. For an asset held at depreciated cost, the amount to be recovered on sale should equal the residual value assumed for depreciation purposes, although it should not exceed the carrying value of the asset. The balance, ie the expected future depreciation charges, is the amount expected to be recovered through use.
- Step 2** Identify the tax deductions expected to be available in accordance with the expected manner of recovery of the asset to determine the asset's tax base for use and for sale. In some jurisdictions this may result in a 'negative' tax base for a recovery of previous tax allowances, only effective when the asset is sold. In other tax jurisdictions, tax bases may be based on original cost with some tax deductions during the use period and the remaining balance, if any, deductible on sale. The entity then has to split the overall tax base into the parts that are expected to apply for the sale and use of the asset, respectively.
- Step 3** Calculate the temporary differences of the asset applicable to the use and the sale elements of the asset by subtracting the tax bases from their respective proportions of the asset's carrying amount.
- Step 4** Determine the tax rate(s) applicable to the use and sale of the asset and multiply them by the relevant temporary differences to calculate deferred tax assets and/or deferred tax liabilities for the use and sale element of the asset.

The split of the accounting base of investment property is more usually arrived at by determining the amount expected to be recovered through use first. This is done by reference to future rentals. Therefore, the split between use and sale is determined by reference to the use element rather than through the residual value of the asset, ie the sale element.

The amount to be recovered through use is the present value of the future rental streams for the period management expects to hold the investment property before disposal. In many instances, management may not identify when they expect individual investment properties to be sold. Where plans are in place to dispose of investment properties, management will be able to make such an assessment.

For others, management may need to estimate average expected holding periods based on the past churn of their investment property portfolio.

Integrating initial recognition exemptions into the calculation

In implementing dual intentions into the calculation of deferred taxes, initial recognition exemptions need to be taken into consideration. As set out in IAS 12.15(a) and IAS 12.24 respectively, temporary differences arising upon initial recognition of an asset or a liability outside a business combination are not recognised when accounting for deferred taxes. To comply with this exception to the underlying principle in IAS 12, an entity therefore needs to identify temporary differences that exist upon the initial recognition of an asset. This 'exempted' amount is carried forward and continues to affect the amount of deferred taxes recognised in later periods (IAS 12.22(c)). This is also appropriate if the entity uses a blended measurement approach and temporary differences are identified for the use and sale elements of an asset at its initial recognition.

In addition, where deductible temporary differences result from the application of the blended measurement method, the general requirements of IAS 12 apply with regard to the recoverability of deferred tax assets. Any deferred tax liability and recognised asset may then qualify to be offset. However, this needs to be determined based on the specific circumstances in accordance with IAS 12.74.

Example 17

On 31 December 20X1 Company A purchases a building which is considered to be an investment property to be accounted for at fair value under IAS 40 *Investment Property*. The initial cost of the building is £2,000. According to A's investment strategy, A will hold the investment property for 7 years and then sell the asset. A determines:

- that £1,400 is expected to be recovered through use and £600 through sale
- that the entity will not be entitled to any tax deductions during the holding period, thus the use tax base is nil
- any profit from the sale of the asset will be taxed at a capital gains tax rate of 28%, with taxable profits equalling sale proceeds less original cost of the investment property asset and
- A's regular income tax rate of 28% will apply to rental income.

	Carrying amount £	Tax base £	Initial temporary difference £	Tax rate %	Deferred tax liability/ (asset) £
recovery through use	1,400	0	1,400	28	392
recovery through sale	600	2,000	(1,400)	28	(392)

In accordance with the initial recognition exemptions, IAS 12.15(b) and IAS 12.24, no deferred taxes are recognised in A's financial statements when the asset is purchased. However, this exemption does not apply if the asset is acquired in a business combination. In a business combination, the potential deferred tax asset relating to the sale element of the carrying amount would need to be tested for recoverability separately from any deferred tax liability before considering offsetting the two amounts in the statement of financial position.

At 31 December 20X2 the investment property is revalued in accordance with the fair value model of IAS 40. The new carrying amount of the asset is £2,400, of which Company A expects to recover £1,800 through use and £600 through sale. Using the blended measurement method as described above, but considering the initial recognition difference for the use and the sale component of the asset's carrying amount, the computation for deferred taxes is as follows:

	Carrying amount £	Tax base £	Current temporary difference (A) £	Initial temporary difference (B) £	Remaining temporary difference (A – B) £	Tax rate %	Deferred tax liability/ (asset) £
recovery through use	1,800	0	1,800	1,400	400	28	112
recovery through sale	600	2,000	(1,400)	(1,400)	0	28	0

As a result, a deferred tax liability will be recognised only for the revaluation increase of the asset. The initial recognition difference exemption applies to the remaining temporary differences identified at the reporting date.

The deferred tax expense is recorded in profit or loss, as it relates to a revaluation that is recognised in profit or loss in accordance with IAS 40. If the asset in question were an item of property, plant and equipment for which a revaluation is recognised in other comprehensive income, the deferred tax consequences would also be recognised in other comprehensive income (IAS 12.61A).

Example 18

Company A has been operating an asset since 1 January 20X1, which it originally intended to use until the end of its useful life, initially expected to be twelve years. The asset is currently accounted for under the cost model of IAS 16 *Property, Plant and Equipment*, using the straight-line method of depreciation. Originally, the tax deductions available equalled the original cost of the asset at £1,200 and no initial recognition difference was identified. The tax deductions are available at an annual allowance of 12.5% of the original cost of the asset for eight years. Any capital gains resulting from a sale of the asset will be taxable and have to be calculated at sale proceeds less any unused tax deductions at the date of sale. The use benefits of the asset will be taxed at 20% whereas the sale profit of the asset will be subject to a capital gains tax rate of 40%.

On 1 January 20X4, after the asset was purchased, the entity changes its intentions. As new technical alternatives to the asset become available, the entity now intends to dispose of it by sale and is looking for an adequate replacement. Nevertheless, the asset will be used for two more years, ie until 31 December 20X5, and no immediate plan to sell the asset exists. Company A expects to recover a residual value of £550 on sale.

Based on the original intentions of entity A, the carrying amount of the asset, its tax base and the resulting deferred tax liability can be projected as follows:

Year	Projection of carrying amount		Tax base projection		Projection of deferred taxes		
	Depreciation £	Carrying amount £	Tax allowance £	Tax base £	Temporary difference £	Tax rate (use) %	Deferred tax liability
20X1	100	1,100	150	1,050	50	20	10
20X2	100	1,000	150	900	100	20	20
20X3	100	900	150	750	150	20	30
20X4	100	800	150	600	200	20	40
20X5	100	700	150	450	250	20	50
20X6	100	600	150	300	300	20	60
20X7	100	500	150	150	350	20	70
20X8	100	400	150	0	400	20	80
20X9	100	300	0	0	300	20	60
20Y0	100	200	0	0	200	20	40
20Y1	100	100	0	0	100	20	20
20Y2	100	0	0	0	0	20	0

At 31 December 20X3, the asset's carrying amount is £900 and the tax base is £750, resulting in a deferred tax liability of £30 as explained above.

As the management of Company A has changed its intentions at the beginning of 20X4, the expected sale at 31 December 20X5 needs to be implemented into a new depreciation schedule as well as the residual value of £550 that the entity expects to recover on sale. This change in accounting estimate needs to be applied prospectively in accordance with IAS 8.36, thus resulting in an increased depreciation charge of £175 for the year ending 31 December 20X4 and a carrying amount of £725 at the reporting date. The revised projection of the asset's carrying amount may be summarized as follows:

Revised projection of carrying amount		
Year	Depreciation £	Carrying amount £
20X3	100	900
20X4	175	725
20X5	175	550

At 31 December 20X4, the change in Company A's intentions regarding the asset is implemented into the deferred tax calculation using a blended measurement approach. The entity expects to recover £550 of the total carrying amount through the sale of the asset, which therefore should be considered as the sale element of the asset's carrying amount. The use element is the total carrying amount less the sale element £175 (£725 – £550), which is equal to the expected depreciation charge for the asset in its final year of use.

Applying the same methodology to the tax deductions, the tax base for the use element is equal to one year's tax allowance at £150. The tax base of the sale element is the remaining balance of the tax deductions, which is equal to the initial cost of the asset less tax allowances utilised until the projected date of sale, ie £450 (£1,200 – 5 × 150). Company A therefore needs to recognise a deferred tax liability of £45 at the end of 31 December 20X4:

	Carrying amount £	Tax base £	Temporary difference £	Tax rate %	Deferred tax liability/ (asset) £
recovery through use	175	150	25	20	5
recovery through sale	550	450	100	40	40
Total	725				45

Any changes in the deferred tax liability should be recognised in profit or loss (IAS 12.58). It should also be noted that the initial recognition exemption does not affect the measurement of the deferred tax liability in this example, as the initial cost of the asset equalled available future tax deductions when the asset was recognised. In addition, the sale of the asset was not originally anticipated by the entity, but has been taken into consideration after the asset's initial recognition.

The above example is a simplification which ignores the impact of indexation. The impact of indexation on the tax base of an asset is discussed in section 8.3.

5 Avoiding pitfalls – business combinations and consolidated accounts

Avoiding pitfalls – business combinations and consolidated accounts

Business combinations offer an added level of complexity to the reporting of deferred taxes. This section considers a number of practical issues that can arise, specifically:

- whether deferred tax should be recognised on intangible assets acquired in a business combination
- where deferred tax arises on assets acquired in a business combination, whether the tax rate to be applied is that of the acquiree or acquirer
- where deferred tax is recognised in a business combination, whether this leads to an immediate impairment of goodwill
- the provision of deferred tax on unrealised intra-group profits eliminated on consolidation.

5.1 Intangible assets arising on a business combination

IFRS 3 requires intangible assets acquired in a business combination to be recognised at their fair value in the consolidated statement of financial position. The UK tax regime calculates tax using the separate financial statements of the members of the group, and not the consolidated accounts. Hence, if an asset arises only on consolidation, its tax base will be nil. This is because, in general, the income earned whilst the asset is used will be taxable and there will be no tax deductions available against that income from the use of the asset. Equally, if such an asset were sold, in general, there would be no tax deduction on disposal.

This results in a temporary difference equal to the carrying value of the asset on initial recognition in the consolidated accounts. As the intangible asset and the related deferred tax arise on a business combination, the other side of the entry is to goodwill under IAS 12.66, see Section 2.2.

As the intangible asset is amortised, the temporary difference will decrease. The reduction in the deferred tax liability will be recognised in profit or loss. The recognition of this deferred tax credit to profit or loss reduces the impact of the amortisation of the intangible asset on profits for the year.

Example 19

Both Companies A and B are UK companies paying only UK Corporation Tax at 28%. Company A prepares IFRS group accounts.

Year 1

On 31 December 20X1 Company A acquires Company B for £1,000,000. At that time Company B has net assets of £500,000. Company A undertakes a fair value exercise and does not identify any fair value adjustments to the net assets of Company B; however it does identify a number of customer contracts that have a fair value, in aggregate, of £250,000.

In preparing its consolidated accounts, Company A must recognise this identifiable intangible asset and provide deferred tax on the difference between the asset's carrying amount of £250,000 and tax base of nil at 28%, leading to a deferred tax liability of £70,000.

Therefore in the consolidated accounts of Company A goodwill is recognised of £320,000 ($£1,000,000 - £500,000 - £250,000 + £70,000$).

Year 2

At 31 December 20X2 the consolidated accounts show accumulated amortisation of £50,000. Therefore the intangible asset has an accounting base of £200,000, which is also the taxable temporary difference at 31 December 20X2. There is therefore a resulting deferred tax liability of £56,000. The amortisation of £50,000 and the reduction in the deferred tax liability of £14,000 will both be recognised in profit or loss.

5.2 Whose tax rate should be applied to fair value adjustments arising in a business combination?

The tax base of an asset is the amount that will be deductible for tax purposes in future periods (IAS 12.7). The tax base of an asset may depend on whether the asset is intended to be used or sold. As set out in Section 4, it is important to establish how an entity will recover the carrying amount of its assets, because this may affect the tax base and the tax rate to be applied.

When considering the provision of deferred tax on assets, the principle in IAS 12 is to consider whether the recovery of the asset will lead to future economic benefits that are taxable. Assuming that a group intends to continue to hold the acquired asset and use it to generate taxable profits in the acquired subsidiary, it is the tax rate that applies to that subsidiary's taxable profits that should be used in calculating the relevant deferred tax provision.

Example 20

Company A acquires Company B on 17 October 20X1. Both Company A and B are trading companies, and for the purposes of IFRS 3 this acquisition is treated as an acquisition of B by A. Company A does not pay tax, ie it is subject to a nil rate of tax in its jurisdiction. Company B pays tax at a rate of 28%.

On the acquisition, Company A performs a fair value exercise which identifies an intangible asset with a fair value of £250,000. This intangible asset has a tax base of nil, ie no deductions will be available against taxable profit as this asset is recovered.

Therefore, as the intangible asset has a carrying value of £250,000 and a tax base of nil, it has a temporary difference of £250,000. As the intangible asset relates to the subsidiary, its carrying value will be recovered through that subsidiary making future taxable profits, which will be taxed at a rate of 28%.

Therefore a deferred tax liability of £70,000 ($£250,000 \times 28\%$) should be provided. The same analysis holds true for other fair value adjustments recognised in a business combination.

5.3 Can the recognition of deferred tax on intangibles create goodwill which is immediately impaired?

In some situations the recognition of deferred tax on an intangible asset acquired in a business combination can result in a goodwill figure which appears to be immediately impaired.

IAS 36 *Impairment of Assets* requires goodwill to be tested annually for impairment. Goodwill is impaired where the recoverable amount of the cash-generating unit (CGU) to which it is allocated, is lower than its carrying amount. Recoverable amount is the higher of the value in use and fair value less costs to sell, IAS 36.6. IAS 36.50 states:

Estimates of future cash flows shall not include:

- cash inflows or outflows from financing activities, or
- income tax receipts or payments.

As a result the value in use calculation cannot include tax cash flows, ie they must use pre-tax cash flows. IAS 36.75 separately requires the carrying value of a CGU to be calculated in a manner consistent with the determination of the value in use of that CGU. Hence, to be consistent with the manner in which the value in use is calculated, the deferred tax liability arising on business combinations should not be included in the net assets of the CGU tested for impairment. This can give rise to problems as demonstrated by the following example.

Example 21

Company A acquires Company B. Both Company A and B are trading companies, and for the purposes of IFRS 3 this acquisition is treated as an acquisition of B by A.

The fair value of the consideration, all cash, given by Company A is £1,000. The only identifiable asset in the business combination is an intangible asset with a value of £1,000. The tax base of that intangible asset is nil and both Company A and Company B pay tax at the rate of 28%. Therefore, there is a taxable temporary difference arising on the recognition of this intangible of £1,000 and a deferred tax liability of £280 must be recognised (£1,000 × 28%).

This transaction would be recognised in the consolidated financial statements as follows:

	Debit £	Credit £
Intangible assets	1,000	
Goodwill (balancing figure)	280	
Cash		1,000
Deferred tax		280

Assuming that the fair value of the consideration transferred was arrived at using value in use calculations and that the £1,000 represented a fair price for the business, the need to exclude the deferred tax liability from the net assets of the CGU will result in an apparent immediate impairment charge of £280. This is because the value in use calculations to support the purchase price would take account of the expected future tax cash flows. However, as set out above, IAS 36 prohibits the inclusion of tax balances and tax cash flows in the net assets allocated to the CGU and the calculation of value in use of the CGU respectively.

The value of the net assets assigned to this CGU is £1,280, ignoring the deferred tax liability derived above, (Intangible asset £1,000 + Goodwill £280). As the value in use calculation supported a consideration of £1,000 there is an apparent impairment of £280 (£1,280 – £280).

A number of arguments exist to avoid this apparent need for an immediate impairment charge and these are set out below.

In many circumstances where a company which held only one asset was acquired, this combination would be accounted for as an asset purchase and not a business combination, IFRS 3.4 (IFRS 3R.3). As such the initial recognition exemption in IAS 12 would generally be available, see section 1.3.

Was a fair price paid? Is the CGU's value supported by its fair value less costs to sell?

The assessment of whether goodwill is impaired will depend on the particular circumstances of the business combination. For example, there may be circumstances where the payment for the business does not represent a fair price for the acquired business in which case an immediate impairment of the goodwill may arise.

The example above assumed that the payment for the acquired business represented a fair price. Given this assumption, it is clear that there should not be an immediate impairment

charge because the combined group has not suffered a loss. Indeed, this assumption provides a justification for not recognising this impairment charge.

Given that we have assumed that the £1,000 is a fair price for the business combination, IAS 36 would determine this as the fair value less costs to sell of the acquired business, if the costs to sell were likely to be immaterial. The recoverable amount would still be £1,000. However the net assets of the CGU would include the deferred tax liability, as the fair value less costs to sell calculation is usually a post-tax assessment. There would therefore be no immediate impairment charge.

This may help justify the carrying value of the goodwill immediately after acquisition. However, in circumstances where it is difficult to continually monitor the fair value less costs to sell of a CGU, this is unlikely to provide an adequate ongoing solution. Where there is an absence of external transactions against which this valuation might be benchmarked, it may prove difficult to continually monitor the fair value less costs to sell of a CGU.

Does significant headroom exist to justify the carrying value of the goodwill?

The example used above is a very simplified example of a business combination where there is no headroom in the value-in-use calculation leading to an assessment that there is an apparent immediate impairment of the goodwill arising on the business combination. In real life, it is logical that a purchaser would expect to make more profits from the acquisition than the fair value paid for that acquisition.

As a result, and because the value in use calculation is entity-specific, even though the deferred tax is ignored in looking at the carrying amount of the CGU there may still be sufficient headroom such that the goodwill is not impaired.

How else can the carrying value of goodwill be justified?

Where it is not possible to justify the carrying value of the goodwill in this way, it may still be possible to avoid an inappropriate impairment charge. IAS 36.76, which amplifies the requirements of IAS 36.75 referred to above, requires that the carrying amount of a cash-generating unit:

- includes the carrying amount of only those assets that can be attributed directly, or allocated on a reasonable and consistent basis, to the cash-generating unit and will generate the future cash inflows used in determining the cash-generating unit's value in use, and
- does not include the carrying amount of any recognised liability, unless the recoverable amount of the cash-generating unit cannot be determined without consideration of this liability.

This is because fair value less costs to sell and value in use of a cash-generating unit are determined excluding cash flows that relate to assets that are not part of the cash-generating unit and liabilities that have been recognised (see IAS 36.28 and IAS 36.43).

This appears to restrict the inclusion of a deferred tax liability in the calculation of value in use. However, IAS 36.78 further states (**emphasis added**):

"It may be necessary to consider some recognised liabilities to determine the recoverable amount of a cash-generating unit. This may occur if the disposal of a cash-generating unit would require the buyer to assume the liability. In this case, the fair value less costs to sell

(or the estimated cash flow from ultimate disposal) of the cash-generating unit is the estimated selling price for the assets of the cash-generating unit and the liability together, less the costs of disposal. **To perform a meaningful comparison between the carrying amount of the cash-generating unit and its recoverable amount, the carrying amount of the liability is deducted in determining both the cash-generating unit's value in use and its carrying amount."**

Whilst this paragraph is relevant to the assessment of the fair value less costs to sell, it can be interpreted to allow some flexibility in applying the requirements of the standard when considering which assets and liabilities can be included in the carrying value of a CGU.

It is arguable that, in order to undertake a meaningful impairment calculation, it is necessary to include this deferred tax liability in the net assets of the cash generating unit. Therefore, in certain circumstances, it may be appropriate to include the carrying amount of this deferred tax liability in the assessment of the carrying value of the CGU to which this goodwill relates. However, it would only be appropriate to include this deferred tax liability in the carrying amount of the CGU. Other deferred tax assets and liabilities arising on the business combination must be excluded from the net assets of the CGU in accordance with IAS 36.50.

5.4 Deferred tax and intra-group profits

IAS 12 requires the recognition of deferred tax on all unrecognised intra-group profits. Where a company in the group has sold stock to another company in the group and this stock remains unsold at the year end the unrealised profit on this intra-group transaction is eliminated at the year-end. Deferred tax then has to be provided on the difference between the carrying value of that stock, which will be after elimination of the intra-group profit, and its tax base, which will be the cost of the stock in the acquiring company, ie before elimination of the intra-group profit.

Where the two group companies pay tax at different rates, the acquiring company's tax rate should be applied to this temporary difference to calculate the deferred tax provision. This is because the tax rate and tax base of the asset must be consistent. The tax base is the deduction that will be available in the future, as this is the cost in the acquiring company's financial statements, so the tax rate will also be that of the acquiring company.

Example 22

Company A purchases inventory for £10,000 on 30 November 20X1. On 15 December 20X1 Company A sells this inventory to its wholly-owned subsidiary Company B for £12,500. At 31 December 20X1 the inventory remains unsold by Company B.

Company A pays tax at the rate of 28%. Company B is domiciled in a country where the corporation tax rate is 20%. Company B will receive the cost of the inventory as a deduction against taxable profits.

Company A prepares consolidated financial statements in which the inventory is restated to £10,000, ie the intra-group profit of £2,500 is eliminated. This stock has an accounting base of £10,000 and a tax base of £12,500. There is therefore a taxable temporary difference of £2,500 (£10,000 – £12,500). Therefore, a deferred tax liability of £500 is recognised (£2,500 × 20%).

6 Avoiding pitfalls – share-based payments

Avoiding pitfalls – share-based payments

This section looks at two particular issues that arise in accounting for deferred tax arising on share-based payments, specifically:

- how to calculate the amount to be recognised in equity and the amount to be recognised in profit or loss
- how to account for deferred tax on share-based payments not caught by the measurement provisions of IFRS 2.

6.1 Calculating the credit to equity

As set out in Section 2.1, IAS 12 requires a deferred tax asset to be recognised for deductible temporary differences associated with equity-settled share-based payments. Typically, the UK tax regime provides for a deduction against corporation tax when share options are exercised. The deduction available is equal to the intrinsic value of the share options at the date they are exercised.

As set out in Section 2.1, IAS 12.68C requires any deferred tax credit arising on equity-settled share-based payments to be allocated between profit or loss and equity.

What amount should be credited in profit or loss?

In the simple example in Section 2.1, the amount of the deferred tax credit to be taken to profit or loss was simply the current year's share-based payment charge multiplied by the effective tax rate. However, this will not always be the case. Whether any amount should be taken to equity in a given year depends on whether or not there is an 'excess tax deduction'.

To see whether there is an excess tax deduction, the total expected tax deduction to date should be compared to the cumulative IFRS 2 expense to date. If the expected tax deduction is greater, then there is an excess tax deduction. The total expected tax deduction to date is calculated as the number of options expected to be exercised multiplied by their intrinsic value at the reporting date multiplied by the proportion of the vesting period completed.

The number of options expected to be exercised might not necessarily be the same as the number of options expected to vest under IFRS 2.

The cumulative amount of deferred tax that should be taken to equity is then this excess tax deduction multiplied by the effective tax rate. The amount to be taken to equity in a year is then this cumulative total minus the amounts already recognised directly in equity. The amount that should be recognised in profit or loss is then the difference between the total deferred tax credit or debit for the year and the amount taken to equity in that year.

Example 23

On 1 January 20X1 Company A issues 1,000,000 options. These share options vest after three years from the date of grant and have an exercise price of £2.50.

Year 1

At 31 December 20X1 the market value of Company A's shares is £3.25, therefore the share options have an intrinsic value of £0.75 (£3.25 – £2.50). At the year end the company estimates that only 595,000 options will vest and will also be exercised. The share-based payment charge recognised in profit or loss in the year is £69,417.

The total expected tax deduction to date is £148,750 ($595,000 \times 0.75 \times 1/3$). The cumulative share-based payment charge to date is £69,417. There is therefore an excess tax deduction of £79,333 (£148,750 – £69,417).

The amount of deferred tax that should be recognised directly in equity is therefore £22,213 (£79,333 × 28%), and the amount that should be recognised in profit or loss is £19,437 ((£148,750 × 28%) – £22,213).

The journal to record this deferred tax asset will therefore be:

	Debit £	Credit £
Deferred tax asset	41,650	
Deferred tax income (profit or loss)		19,437
Deferred tax income (equity)		22,213

The deferred tax should be recognised in the statement of financial position subject to there being sufficient future taxable profits against which this deferred tax asset can be recovered.

Year 2

At 31 December 20X2, the market value of the shares is £3.50; therefore the share options have an intrinsic value of £1 (£3.50 – £2.50). At the year end, the company estimates that 600,000 options will vest and that all of the options that vest will be exercised. The share-based payment charge recognised in profit or loss in the year is £70,583.

The total expected tax deduction to date is £400,000 ($600,000 \times 1 \times 2/3$). The cumulative share-based payment charge to date is £140,000 (£70,583 + £69,417). There is therefore an excess tax deduction of £260,000 (£400,000 – £140,000).

The cumulative amount of deferred tax that should be recognised directly in equity is therefore £72,800 (£260,000 × 28%). The amount that has previously been recognised directly in equity is £22,213, therefore the amount that should be recognised directly in equity this year is £50,587 (£72,800 – £22,213).

The deferred tax asset at the end of the previous year was £41,650. The deferred tax asset that should be recognised at the end of 2006 is £112,000 (£400,000 × 28%); this gives an increase in the deferred tax asset of £70,350 (£112,000 – £41,650). The amount that should be recognised in profit or loss is £19,763 (£70,350 – £50,587).

The journal to record this deferred tax asset will therefore be:

	Debit £	Credit £
Deferred tax asset	70,350	
Deferred tax income (profit or loss)		19,763
Deferred tax income (equity)		50,587

Year 3

At 31 December 20X3, the market value of the shares is £3.15; therefore the share options have an intrinsic value of £0.65 (£3.15 – £2.50). At the year end the company estimates all of the options that have vested will be exercised, 750,000. The share-based payment charge recognised in profit or loss in the year is £122,500.

The total expected tax deduction to date is £487,500 (750,000 × 0.65). The cumulative share-based payment charge to date is £262,500 (£140,000 + £122,500). There is therefore an excess tax deduction of £225,000 (£487,500 – £262,500).

The cumulative amount of deferred tax that should be recognised directly in equity is therefore £63,000 (£225,000 × 28%). The amount that has previously been recognised directly in equity is £72,800; therefore the amount that should be recognised in equity is in fact a debit of £9,800 (£63,000 – £72,800), ie a reversal of part of the credit already taken to equity.

The deferred tax asset at the end of the previous year was £112,000. The deferred tax asset that should be recognised at the end of 20X3 is £136,500 (£487,500 × 28%); this gives an increase in the deferred tax asset of £24,500. The amount that should be recognised in profit or loss is £34,300 (£24,500 + £9,800).

The journal to record this deferred tax asset will therefore be:

	Debit £	Credit £
Deferred tax asset	24,500	
Deferred tax income (profit or loss)		34,300
Deferred tax income (equity)	9,800	

6.2 Deferred tax on share options not caught by the measurement provisions of IFRS 2

IFRS 1.25B *First-time Adoption of International Financial Reporting Standards* (Paragraph D2 in IFRS 1 Revised 2008) provides an exemption from recognising the IFRS 2 expense relating to equity-settled share-based payments granted prior to 7 November 2002, or equity-settled share-based payments granted after this date but which vest prior to the later of 1 January 2005 and the date of transition to IFRS. As set out above, IAS 12.68C requires that where the expected tax deduction exceeds the related cumulative IFRS 2 remuneration expense the tax effect of that excess should be recognised in equity.

Where, in accordance with the transitional provisions of IFRS 1, there is no cumulative remuneration expense, a question arises as to where the deferred tax associated with these equity-settled share-based payments should be recognised. IFRS 1 contains no similar exemption from recognising the deferred tax on options which:

- were granted before 7 November 2002 or
- vested before the later of date of transition to IFRS and 1 January 2005.

As no expense is recognised in profit or loss in relation to these grants then, arguably, the entire deferred tax relating to these grants should be taken direct to equity. This includes both the deferred tax on such grants recognised on transition to IFRS and subsequent movements in the deferred tax relating to these share-based payments.

7 Avoiding pitfalls – recognition of deferred tax assets

Avoiding pitfalls – recognition of deferred tax assets

The recognition of deferred tax assets is subject to specific requirements in IAS 12. These require a deferred tax asset to be recognised to the extent that it is probable that the deferred tax asset will be recovered. This section covers:

- the recoverability of deferred tax assets where taxable temporary differences are available
- the length of lookout periods for assessing the recoverability of deferred tax assets
- the measurement of deferred tax assets in interim financial statements.

7.1 Recoverability of deferred tax assets where taxable temporary differences are available

In assessing whether future taxable profits will be available against which deductible temporary differences, unused tax losses and tax credits can be utilised, entities need to take into account various evidence. IAS 12.28 explains that taxable temporary differences relating to the same taxation authority and the same taxable entity as the deductible temporary differences are one source of evidence that taxable profits will be available.

If these compatible taxable temporary differences will reverse in the same periods as the deductible temporary differences or in periods into which tax losses may be carried back or forward, deferred tax assets should be recognised (IAS 12.28 and 36). In other words, deferred tax assets should be recognised, at a minimum, to the extent of existing taxable temporary differences that are likely to negate the effects of any deductible temporary difference, unused tax losses or unused tax credits.

Example 24**Example 24a – deductible and taxable temporary difference relate to the same taxable entity**

On a business combination, an intangible asset is recognised relating to the acquired entity's trade. This intangible asset has a carrying amount of £200 at the date of the combination. Under the applicable tax rules, the carrying amount of the asset is not tax-deductible and there is also no tax deduction available on the sale of the asset. The tax base of this intangible asset therefore is nil and no other temporary difference exists.

The acquired business has accumulated unused tax losses of £5,000 that can be deducted from any future taxable profit. The unused tax losses are not subject to any expiry date or limited to a certain type of taxable income. The acquired business, however, is not expected to become profitable in the foreseeable future. Therefore the entity needs to record two deferred tax items:

- a deferred tax liability based on the taxable temporary difference of £200 on the intangible asset
- a deferred tax asset for its unused tax losses. As the acquired entity is not likely to become profitable in the foreseeable future, deferred taxes based on its unused tax losses should only be recognised to the extent of taxable temporary differences that arise upon the recognition of the intangible asset, ie £200.

Upon their initial recognition in the course of the business combination, both deferred tax items should be included in the calculation of goodwill or excess of the acquirer's interest in the acquiree's net assets over the cost of the combination (IAS 12.66).

Example 24b – deductible and taxable temporary difference relate to different components of performance

An entity records an available-for-sale financial asset (AFS asset) at an initial cost of £100, which is equal to its tax base. At the reporting date, the fair value of the AFS asset is £130, thus resulting in a pre-tax gain of £30, which is recognised in other comprehensive income (IAS 39.55(b)). The tax base of this asset is not affected by the rise in fair value.

The entity also has accumulated unused tax losses of £8,000 that can be deducted from any future taxable profit and are not subject to any expiry date or limited to a certain type of taxable income. Again, the entity is not expected to generate taxable profits in the foreseeable future. Based on these circumstances, the entity needs to record two deferred tax items:

- a deferred tax liability based on the taxable temporary difference of £30 on the gain arising on the revaluation of the AFS asset, as the tax base is not affected by its new carrying amount
- a deferred tax asset for its unused tax losses. As the entity does not expect taxable profits in the foreseeable future, a deferred tax asset for unused tax losses should only be recognised to the extent of existing taxable temporary differences, ie £30.

The deferred tax liability arising on the revaluation of the AFS asset is recognised in other comprehensive income, as the underlying transaction is also recognised in other comprehensive income (IAS 12.58(a)). However, the deferred tax asset relates to unused losses and so gives rise to a deferred tax income in profit or loss, because it does not relate to a business combination or a transaction that is recognised in other comprehensive income.

7.2 Lookout periods for future taxable profits

Deferred tax assets arising from available tax losses are recognised if the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available (IAS 12.35). Entities may therefore look forward for a number of future accounting periods to determine whether they will have sufficient taxable profit to justify recognising a deferred tax asset.

In these circumstances, there is no specific restriction on how many years the entity may look forward, unless there is a date at which the availability of the tax losses expires. The uncertainties of the future mean that the evidence supporting future profits in later periods will generally not be as convincing as that for earlier periods, but there is no rule for how many years in the future can be taken into account. The facts and circumstances of the situation in question will determine the appropriate period.

The unavailability of detailed profit forecasts is not necessarily a bar to assuming that profits for later years are available to support a deferred tax asset. If there are detailed forecasts showing profits for the next three years, it may be unlikely that profits would reduce to nil in year four. The key issue is that the profits are probable and that there is convincing evidence to that effect.

7.3 Recognition of deferred tax assets in interim financial statements

The recoverability of deferred taxes should be re-assessed at the end of each reporting period using the criteria set out in IAS 12.36. If the re-assessment results in an increase or decrease of the amount recognised for deferred tax, the change is recorded in profit or loss, unless it relates to another component of the financial statements as discussed in Section 2. Most changes in the carrying amount of recognised deferred tax assets therefore affect the average effective tax rate of an entity, ie income tax expense or income divided by the accounting profit, as defined by IAS 12.86. This includes both deferred taxes and current taxes.

IAS 34 *Interim Financial Reporting* requires an entity to apply the same accounting policies in its interim financial statements that it applies in its annual financial statements (IAS 34.28). This basic principle suggests that deferred tax assets should therefore be tested for recoverability and adjusted as necessary at the end of the interim reporting period. So, for example, if an entity determines at the end of an interim reporting period that a previously unrecognised deferred tax asset will be recoverable in full, it seems that it should recognise an asset in the interim statement of financial position. However, the corresponding entry in profit or loss will give rise to an increase or decrease in the effective income tax rate for that interim financial period.

This seemingly contradicts the specific measurement principle for income tax expense in interim financial statements, which requires that income tax expense should be recognised "in each interim period based on the best estimate of the weighted average annual income tax rate expected for the full financial year" (IAS 34.30(c)). Interim income tax expense therefore is calculated by applying to an interim period's pre-tax income the tax rate that would be applicable to expected total annual earnings, that is, the estimated average annual effective income tax rate. This concept is further explained in IAS 34 Appendix B paragraphs B12 to B16. IAS 34.B13 explains that this is consistent with the requirement of IAS 34.28 because income taxes are assessed on an annual basis so an annualised approach is needed in interim accounts.

Therefore, a two-step approach may be required for deferred tax assets in interim periods. Firstly, whether or not a deferred tax asset can be recognised is assessed at the interim date

using IAS 12.36. Secondly, the calculation of the amount to be recognised in the interim accounts is then determined using a combination of the amount expected to be recognised as recoverable at the end of the full financial year and the estimated annual effective income tax rate in accordance with IAS 34.30(c).

IAS 34.B20 to B22 deal with a case where the probability of future taxable profits is reassessed in the first interim period such that a previously unrecognised deferred tax asset is considered recoverable within the current full accounting year. In this case, the deferred tax asset is not recognised at the end of the interim period but is instead recognised within the calculation of the tax expense for the period as follows:

Example 25

Company A reports quarterly and has operating losses to carry forward of £10,000 for income tax purposes at the start of the current financial year for which a deferred tax asset has not been recognised. Company A earns £10,000 taxable profits in the first quarter of the current year and expects to earn £10,000 in each of the three remaining quarters. Excluding the carry forward, the estimated average income tax rate is expected to be 40%.

The taxable income for the current year is therefore expected to be £30,000 (£10,000 × 4 – £10,000 loss carried forward) and the tax payable will be £12,000 (£30,000 × 40%). This gives an effective annual tax rate of 30% (£12,000 ÷ 40,000).

The tax expense for each interim period is calculated as 30% of actual earnings in the period, as follows:

	Quarter 1	Quarter 2	Quarter 3	Quarter 4	Annual
	£	£	£	£	£
Tax expense	3,000	3,000	3,000	3,000	12,000

Where the probability of future taxable profits is such that the whole of the deferred tax asset is not considered recoverable in the current year, a deferred tax asset will be recognised in the statement of financial position at the end of the financial year, assuming that future taxable profits are expected against which it can be recovered. The estimated deferred tax asset to be recognised at the end of the year should be built into the calculation of the estimated annual effective income tax rate. An example of how this can be achieved is demonstrated below:

Example 26

Company A reports quarterly and operates in a tax jurisdiction with a 40% tax rate. Company A has operating losses to carry forward of £40,000 for income tax purposes at the start of the current financial year, which can be offset against profits for the current and the next financial year only. At the start of the year, the entity estimates that £16,000 of the losses can be recovered against profits for the current year and the remaining £24,000 recovered against profits for the next financial year. A deferred tax asset has been recognised in the opening statement of financial position of £16,000 (£40,000 × 40%). The entity earns £4,000 taxable profits in the first quarter of the current year and expectations for the remainder of the year are in line with budget. However, the budgeted profit for the following year has been reduced to £20,000. Consequently, the deferred tax asset to be recognised at the end of the current year should be reduced by £1,600 ((£24,000 – £20,000) × 40%).

Therefore, the estimated effective annual tax rate is: $[(£16,000 \times 40\%) + £1,600] \div £16,000 = 50\%$.

Assuming profit is earned straight-line through the year, the tax expense for each interim period is calculated as 50% of actual earnings in the period, as follows:

	Quarter 1	Quarter 2	Quarter 3	Quarter 4	Annual
	£	£	£	£	£
Tax expense	2,000	2,000	2,000	2,000	8,000

8 Avoiding pitfalls – other issues

Avoiding pitfalls – other issues

This section is a summary of other issues which can arise in practice, namely:

- whether a particular taxation regime meets the definition of an income tax
- the tracking of temporary differences arising on initial recognition
- the accounting for changes in an asset's tax base due to revaluation or indexation of that tax base
- the treatment of deferred tax on gains and losses relating to an available-for-sale financial asset recycled through profit or loss
- accounting for deferred tax on compound financial instruments.

8.1 Definition of an income tax

The scope of IAS 12 is limited to income taxes. These are defined in IAS 12.2 as follows:

"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."

As a result, if taxes are not based on 'taxable profits', they are not within the scope of IAS 12. For example, sales or payroll taxes are not income taxes. These taxes are based on the sales an entity generates or on salaries and wages it pays to its employees.

However, with some other types of tax the question of whether the definition of an income tax is met is less clear. For example, when an entity is not taxed on the basis of its financial reporting accounting profit, the assessment basis of taxation may still be considered taxable profit. The IFRIC has acknowledged that whether a tax is within or outside the scope of IAS 12 is an area of interpretation and has pointed out in one of its agenda rejection decisions that "... the term 'taxable profit' implies a notion of a net rather than gross amount." Therefore, if a tax is based on a net income figure, (ie revenues less deductions) it will generally meet the definition of an income tax and needs to be considered in accounting for current and deferred tax under IAS 12. On the other hand, taxes levied on gross amounts (such as revenues or assets) are generally outside the scope of IAS 12.

Some taxes are assessed on different bases depending on the circumstances. For example, to secure a stable flow of tax payments to the tax authorities or for simplification, taxes may be based not only on taxable profits, but also on another amount such as sales or capital employed. An analysis of whether the tax is an income tax might focus on the assessment basis that is most likely to apply to the entity in practice. Moreover, where a tax may be imputed on an assessment basis that is a substitute for a net income figure, it could be regarded as an income tax within the scope of IAS 12.

One tax commonly substituted for corporation tax in the UK is the tonnage tax regime, typically used in the shipping industry. Whether this falls within the definition of an income tax has been a matter of some debate. In its May 2009 meeting, IFRIC concluded that

tonnage tax is not within the scope of IAS 12 because it is based on gross tonnage and not on net profit.

8.2 Accounting for initial temporary differences after day one

Where initial recognition differences have been identified that are subject to the exemptions set out in IAS 12.15(b) and 24, no deferred taxes are recognised at initial recognition of the asset or liability. Further, subsequent changes in the unrecognised deferred tax asset or liabilities are also not recognised (IAS 12.22(c)). The entity therefore needs to identify exempt initial temporary differences and distinguish them from subsequent temporary differences, which are not subject to the initial recognition exemption.

Changes in temporary differences result from changes in either the carrying amount or the tax base of an asset or liability. IAS 12 does not explain comprehensively how to distinguish changes in temporary differences that relate to initial recognition from subsequent temporary differences.

Subsequent to initial recognition assets and liabilities may be measured in the financial statement at fair values. The resulting changes in the carrying amount affect the asset's or liability's temporary difference. The tax base of an asset or a liability may, alternatively, be subject to an indexation allowance scheme or a revaluation for tax purposes that gives rise to future tax deductions. Both situations raise the question whether the initial recognition difference has been affected or if a subsequent temporary difference has been established.

There are many reasons for subsequent changes in temporary differences. Each needs to be assessed drawing on the guidance in IAS 12. The tax base may also be changed by many different factors. This is therefore an area of interpretation.

One approach to arrive at a consistent accounting policy is to assess whether the change in the temporary difference results from (i) the 'consumption', or use, of the original carrying amount and/or tax base; or (ii) from the revaluation of the asset, liability or tax base. For example, the following may be regarded as a consumption of the original amounts which change pre-existing exempt initial recognition differences:

- the impairment or the reversal of a previous impairment of the original carrying amount
- the depreciation or amortisation of an asset's or liability's original carrying amount, and/or
- the change of the tax base caused by taking tax deductions.

These changes should not affect accounting for deferred taxes. These differences relate to initial recognition and remain exempted in accordance with IAS 12.15(b) or 24.

However, when the asset or liability is revalued, any change between the previous carrying amount and the revalued carrying amount should be considered as a new temporary difference. The initial recognition exemption does not then apply. Deferred tax will or may need to be recognised.

The same principle applies to the corresponding tax base. If future tax deductions are restated or revalued, eg as a result of an indexation allowance scheme, this also establishes a subsequent temporary difference, which therefore should be included in accounting for deferred taxes.

Example 27

On 31 December 20X1, entity A acquires a building for £100. The cost of the building will never be deductible for tax purposes, even upon its eventual disposal. Therefore, the tax base is nil and a taxable temporary difference of £100 arises, for which the initial recognition exemption applies. Hence, no deferred tax liability is recognised in accordance with IAS 12.15(b).

The building is subsequently measured using the revaluation model. It is recorded at its fair value at the date of the revaluation less any subsequent accumulated depreciation and impairment losses in accordance with IAS 16.31. In the years to 31 December 20X2 and 31 December 20X3, the entity depreciates the building over its useful life, considered to be 20 years, so that at the end of the periods, the carrying amount of the building is £95 and £90, respectively. In addition, the building is revalued to its current fair value of £120 at 31 December 20X3, with a corresponding pre-tax gain of £30 (£120 – £90) recorded in other comprehensive income.

The subsequent depreciation of the asset in the years to 31 December 20X2 and 31 December 20X3 could be considered to be a change of the original carrying amount of the building and thus should be considered to be a consumption of the initial temporary difference. The depreciation-related change of the initial temporary difference of £100 should therefore not be included in accounting for deferred taxes. The revaluation of the asset, however, does not relate to the initial temporary difference at all and therefore gives rise to a subsequent temporary difference of £30, in respect of which deferred tax is recognised.

8.3 Changes in an asset's tax base due to a revaluation or indexation

IAS 12.65 explains that an entity must look at the way an asset is subsequently measured when it determines whether the deferred tax effect of a revaluation of the asset for tax purposes should be recognised in other comprehensive income or profit or loss. The deferred tax effect of a revaluation of an asset for tax purposes should only be recognised in other comprehensive income if the revaluation for tax purposes relates to a recent or future revaluation of the asset under IFRS, which will be or has been recognised directly in equity.

Hence, where an asset is not revalued under IFRS, and so there are no adjustments to its carrying amount charged or credited directly to equity, any resulting deferred tax asset or liability from a tax revaluation will give rise to a corresponding income or expense to be included in profit or loss.

IAS 12 does not take into consideration other changes in an asset's tax base. In fact, the Standard does not even define what constitutes a revaluation for tax purposes. Arguably, IAS 12.65 should also be applied to circumstances where the tax base of an asset is subject to an indexation allowance. The principle again is that the deferred tax effect is charged to other comprehensive income if and only if the indexation is 'related' to an accounting revaluation. In most cases, they will be based on different valuation metrics and hence this will not be so.

8.4 Gains and losses relating to an available-for-sale financial asset released through profit or loss

When an available-for-sale financial asset is derecognised, the corresponding cumulative gain or loss previously recognised in other comprehensive income needs to be released through profit or loss (IAS 39.55(b)). IAS 12 is silent on the allocation of deferred tax income or expenses that previously have been charged or credited directly to other comprehensive income.

As the financial asset is derecognised, the corresponding temporary difference ceases to exist. The associated deferred tax asset or liability therefore has to be eliminated. As derecognition of the deferred tax asset or liability is directly related to derecognition of the related available-for-sale financial asset, it should be treated consistently and be recycled through profit or loss.

8.5 Deferred tax on compound financial instruments

IAS 12 takes the view that a temporary difference arising from separation of a compound instrument into its liability and equity component does not relate to initial recognition (IAS 12.23). Consequently, any temporary difference arising is not excluded by the initial recognition exemption and deferred tax must be recognised where applicable.

IAS 12.23 also specifies that:

- the initial deferred tax on a taxable temporary difference resulting from separation of a compound instrument is charged to equity, following the principle in IAS 12.61A that deferred tax is recorded in equity if it relates to an item charged or credited directly to equity in the same or a different period, and
- subsequent changes to this deferred tax liability are recorded in profit or loss, in accordance with IAS 12.58.

The temporary difference is the difference between the carrying amount of the liability component and its tax base. The liability component is determined in accordance with IAS 32 *Financial Instruments: Presentation*.

The tax base of a convertible liability should be determined based on the general definition in IAS 12.8. This can be expressed as the following formula:

$$\text{Tax base (of a liability)} = \text{carrying amount} - \text{future deductible amounts} + \text{future taxable amounts}$$

In many jurisdictions, the initial tax base of a compound instrument is equal to the total proceeds of the instrument, ie the instrument is treated as 'straight' debt for tax purposes, with no separation into debt and equity.

For example, consider an entity that issues a convertible bond for total proceeds of £100, of which £90 is determined to be a liability component and £10 the equity component. The entity will record a liability of £90 on the issue date. Assume that if the issuer settled the instrument on the same day for £90, a taxable gain of £10 would arise under the relevant tax laws. In that scenario the tax base is £100. This is confirmed by applying the following formula for determination of tax bases:

Tax base (of a liability) = carrying amount – future deductible amounts + future taxable amounts

Tax base = £90 – nil + £10

Tax treatment affected by manner of settlement

In some jurisdictions the tax treatment of a compound instrument might depend on whether it is converted or redeemed. For example, notional interest expense included in the liability component, as a result of measurement at amortised cost using the effective interest method, might be deductible for tax purposes only if the bond is redeemed. In accordance with IAS 12.51-52, measurement of deferred tax should reflect the expected manner of settlement. The manner of settlement might affect the tax base, the tax rate, both or neither.

When a deductible temporary difference arises if the bond is settled in the expected manner, additional analysis is required to determine whether the resulting deferred tax asset qualifies for recognition. A deferred tax asset should be recorded only when it is probable that the entity will have sufficient taxable profits against which the deductible temporary difference may be utilised.

Example 28

Convertible bond with tax base not affected by manner of settlement

Company A issues a convertible bond for £800 on 1 January 20X1. No interest will be paid. The bondholders can convert each bond into a fixed number of equity shares of Company A on 31 December 20X5. The bond must be redeemed, if not converted, for £800 on 31 December 20X5.

On 1 January 20X1, Company A determines that the market interest rate for a similar bond with no conversion option is 2.71%. On this basis, the liability component of the bond is determined to be £700. The liability is to be measured at amortised cost using the effective interest rate.

Under the relevant jurisdictional tax laws, the bond is regarded as a loan of £800. The imputed interest charges are not tax deductible. Conversion of the bond has no additional tax consequences. The applicable tax rate is 28%.

The tax base of the bond is £800. A taxable temporary difference of £100 therefore arises on initial recognition. A deferred tax liability of £28 (£100 × 28%) is recorded on 1 January 20X1. In accordance with IAS 12.23, the corresponding charge is recorded in equity.

The respective entries on 1 January 20X1 are as follows:

	Debit £	Credit £
Cash	800	
Equity - conversion option		100
Financial liability		700
Deferred tax liability		28
Equity - deferred tax	28	

The subsequent accounting entries for 20X1 to 20X5 are summarised below:

	20X1	20X2	20X3	20X4	20X5
	£	£	£	£	£
carrying amount of liability - opening	700	719	738	758	779
Imputed interest expense	19	19	20	21	21
Carrying amount of liability - closing	719	738	758	779	800
Tax base	800	800	800	800	800
Taxable temporary difference - opening	100	81	62	42	21
Taxable temporary difference - closing	81	62	42	21	0
Deferred tax liability at 28% - opening	0	22.7	17.4	11.8	5.9
- charged to equity on initial recognition	28.0	0	0	0	0
- credited to profit or loss	(5.3)	(5.3)	(5.6)	(5.9)	(5.9)
Deferred tax liability at 28% - closing	22.7	17.4	11.8	5.9	0

Example 29

Convertible bond with tax base dependent on manner of settlement

Company A issues a bond on 1 January 20X1 on exactly the same terms as the previous example. The market interest rate is also the same. However, in this case the relevant tax laws differ such that:

- the tax treatment of the bond follows the accounting. Accordingly the tax authorities treat the bond as a debt issuance of £700 and a written warrant of £100, and
- the interest accrued will be deductible if the bond is redeemed but not if converted.

In this case, there is no temporary difference on initial recognition. Consequently, no deferred tax is recorded on 1 January 20X1.

Subsequently, Company A records interest on the liability component. The accrued interest creates a deductible temporary difference because it represents a future deduction that would arise if the liability were settled for its carrying amount. For example, at 31 December 20X4 the carrying amount of the liability is £779, see table above. The tax base is £700 on redemption, but £779 on conversion. The tax base formula confirms this as follows:

Tax base (of a liability) = carrying amount – future deductible amounts + future taxable amounts

Tax base (redemption) = £779 – £79 + nil

Tax base (conversion) = £779 – nil + nil

Accordingly a deductible temporary difference of £79 exists at this date if Company A expects to settle the bond by redemption. A deferred tax asset of £22 (£79 × 28%) is recorded, to the extent that it is probable that Company A will have sufficient taxable profits against which this deductible temporary difference may be utilised. However, if Company A expects the bond to be settled by conversion into shares there is no temporary difference so no deferred tax is recognised.

A Glossary

The following definitions are drawn from the definitions in IAS 12:

Term	Description
Accounting profit	Accounting profit is the profit or loss for a period before deducting tax expense.
Taxable profit (tax loss)	Taxable profit is the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable).
Tax expense (tax income)	Tax expense is the aggregate amount included in the determination of profit or loss for the period in respect of current and deferred tax.
Current tax	Current tax is the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period.
Deferred tax liabilities	Deferred tax liabilities are the amounts of income taxes payable in future periods in respect of taxable temporary differences.
Deferred tax assets	Deferred tax assets are the amount of income taxes recoverable in future periods in respect of: <ul style="list-style-type: none"> • deductible temporary differences • the carryforward of unused tax losses, and • the carryforward of unused tax credits.
Temporary difference	A temporary difference is a difference between the carrying amount of an asset or liability in the statement of financial position and its tax base. Temporary differences may be either taxable temporary differences or deductible temporary differences
Taxable temporary difference	Taxable temporary differences are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.
Deductible temporary difference	Deductible temporary differences are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.
Tax base	The tax base of an asset or liability is the amount attributed to that asset or liability for tax purposes.
Tax base of an asset	The tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset. If those economic benefits will not be taxable, the tax base of the asset is equal to its carrying amount.
Tax base of a liability	The tax base of a liability is its carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods. In the case of revenue which is received in advance, the tax base of the resulting liability is its carrying amount, less any amount of the revenue that will not be taxable in future periods.

IAS 12 does not define an income tax but the following description is contained in IAS 12.2:

"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."

B Summary of the UK tax regime

The following is a basic guide to the UK tax regime and considers the common elements of taxation. The tax legislation referred to in this Appendix was current as at 1 July 2009. It should be noted that this is a basic guide based on the UK corporation tax regime and if the tax treatment of an item is particularly complex, you may want to speak to your tax adviser to understand the precise tax treatment.

This summary does not consider foreign tax regimes and therefore if you have foreign subsidiaries, you may need to speak to your tax advisers to understand the tax rules that apply in that jurisdiction as this will determine the tax base of assets and liabilities held by that foreign subsidiary.

Underlying asset or liability	Tax treatment
Non-current assets	
Property, plant and equipment	<p>Property Finance Act 2008 legislated for the phasing out of allowances for industrial and agricultural buildings. Balancing allowances and charges on disposal have already been withdrawn. The tax base for such assets in use should therefore be limited to the future allowances available until their withdrawal in 2011. The tax base on sale should be cost plus indexation. Any potential capital loss should be restricted by the amount of capital allowances previously claimed on the asset.</p> <p>The tax base of property may also be affected where the costs of clearing a contaminated or derelict site have been capitalised but an enhanced revenue deduction has been claimed.</p> <p>The land element should always be assumed to be recovered through sale, see Section 1.2 above, and therefore the tax base should be the indexed cost of the land.</p> <p>Indexation is not available where it would create or increase a loss. Accordingly, where the tax deduction available on sale of a property exceeds the associated accounting base (book value), the tax base should be restricted to the higher of original cost of the property and its accounting base.</p> <p>Plant and equipment The tax base of plant and equipment in use should be the future capital allowances available (generally, the tax written down value of the assets).</p>
Investment property	<p>The land element should always be assumed to be recovered through sale and therefore the tax base should be the indexed cost of the land (restricted where a loss would arise, see above).</p> <p>In the UK, as no capital allowances are available for investment properties, the tax base for use is nil. The tax base associated with sale is the indexed cost (restricted where a loss would arise, see above).</p>

Underlying asset or liability	Tax treatment
Goodwill	<p>Goodwill arising only on consolidation, ie not through an acquisition of trade and assets, will have a tax base of nil as no deductions will ever be allowed for this goodwill.</p> <p>Where goodwill is recognised in the separate financial statements of an entity within the group a tax deduction is sometimes available.</p> <p>Goodwill acquired before 1 April 2002 and goodwill acquired in certain intra-group transactions after that date is taxed as a capital asset. Its tax base in use should be nil as there is no ongoing tax relief and its tax base on sale should be indexed cost, subject to ensuring that indexation cannot increase a loss (as for property, see above).</p> <p>For all other goodwill tax relief is generally given for the accounts charge for goodwill amortisation unless an election has been made for a fixed rate annual deduction. Except in such cases, the tax base will usually be equal to the accounting base.</p>

<p>Other intangible assets</p>	<p>The comments for goodwill above also apply to many other intangible assets. However, there are a few items that may be accounted for as intangibles that have other tax treatments:</p> <p>Capitalised research and development Enhanced tax relief is given for qualifying research and development expenditure when the cost is incurred rather than when it is expensed in the financial statements. Therefore, if tax relief has already been given, the tax base for the capitalised amount should be nil.</p> <p>Software It is possible to make an election to disapply the tax rules for intangibles and claim capital allowances instead. In particular, this election might be made to obtain accelerated tax relief for the software and the tax base of that item may, as a result of such an election, be lower than the accounting base.</p> <p>Capitalised borrowing costs Where a loan relationship debit or credit is capitalised in a fixed asset or project, notwithstanding the accounting treatment, the debit or credit must be brought into account for corporation tax. However, this does not apply if the asset is a post 1 April 2002 intangible asset where tax relief is available for the accounts amortisation charge. Where this provision applies, the tax base of the capitalised costs should be nil.</p> <p>Items excluded from the intangibles regime Tax relief is not available for amortisation of the following assets:</p> <ul style="list-style-type: none"> • rights over tangible assets • assets for which a capital allowance has been claimed • oil licences • financial assets • rights in companies, trusts etc • assets held which are not for a commercial purpose <p>Generally this should mean that they are treated as capital assets and their tax base should depend on whether they are held for sale or use. The tax base for use should depend on the availability of capital allowances and their tax base for sale should be the amount that should be deductible in calculating any gain, ie costs plus indexation.</p> <p>Certain highly specialised assets can also be excluded. This is a complex area and if you need any further assistance please contact your tax adviser.</p>
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Associates and joint ventures accounted for using equity accounting	<p>Expected to be recovered through use The tax base in use is based on dividends receivable. All dividends received by UK resident companies are taxable, subject to a range of exemptions. Where the receipt is exempt, the tax base should equal the accounting base. Where a dividend is taxable, the treatment of dividends from foreign companies should depend on the overseas tax rate and whether double taxation relief is available.</p> <p>Expected to be recovered through sale The disposal of these holdings should give rise to a chargeable gain and the tax base should equal the indexed cost unless the substantial shareholding exemption applies. If the substantial shareholding exemption applies, the tax base on sale should equal the accounting base.</p>
Non-current financial assets	<p>The tax base will depend on the nature of the item. Although many financial instruments may be accounted for on a fair value basis, there are a range of 'disregard' regulations that seek to tax gains and losses only arising on a sale, unless the company has chosen to elect out of these rules.</p> <p>The precise tax rules for financial instruments are complex and therefore we recommend you talk directly to your tax advisers to understand how your group will be taxed on the financial instruments it holds.</p>
Current assets	
Inventories	The tax base for inventories or stock should be the same as the carrying amount in the statement of financial position, provided there are no general provisions for stock. Any general provisions should be shown as having a nil tax base.
Trade and other receivables	The tax base should be equal to the carrying amount in the statement of financial position unless there are any general provisions for which the tax base should be nil.
Current financial assets	See non-current financial assets.
Cash and cash equivalents	The tax base for cash should be equal to its carrying amount in the statement of financial position.

Current liabilities	
Trade and other payables	The tax base will generally equal the carrying value unless the expenditure is only deductible when paid.
Short-term borrowings and current portion of long-term borrowings	<p>The tax base should be the same as the accounting base. However, this is provided that a taxable deduction can be taken in respect of loan interest in the same period as the accounts.</p> <p>Where there are interest payments which are deductible in the future when they are paid, the tax base is arrived at by deducting the amount deductible in the future from the accounting base.</p> <p>If there are any payments that will never be deductible, for example because of the debt cap for accounting periods commencing on or after 1 January 2010, then these amounts will not be deducted from the accounting base when calculating the tax base.</p>
Short-term provisions	<p>The tax base for the provision should be equal to the accounting base provided that the provision is specific and does not relate to an item of disallowable expenditure.</p> <p>If the provision will be deductible for tax purposes in the future when the payment is made, rather than when the provision is recognised (for example, remuneration paid more than nine months after the year end), the tax base should equal the accounting base, less the amount that will be deductible in the future. Therefore, if the accounting base of a provision for a bonus is £100 and the bonus is payable 10 months after the year end and the tax deduction will accrue at the time the bonus is paid, the tax base should be nil.</p>
Non-current liabilities	
Long-term borrowings	See short-term borrowings and current portion of long-term borrowings.
Long-term provisions	See short-term provisions.
Retirement benefit liabilities	The tax deduction for pension contributions is based on what has actually been paid within the year. Therefore, if there is a liability, a tax deduction can only be claimed when the amount is paid. The tax base will therefore be nil.
Items without an accounting base	
Carried forward losses	<p>The tax base should be the amount of the loss which can be carried forward.</p> <p>Capital losses can only be carried forward and used against capital gains. There may also be restrictions in the use of other trading or non-trading losses carried forward, which may impact the extent to which the related deferred tax asset can be recognised or offset against deferred tax liabilities.</p>
Equity-settled share-based payments	In the UK, the timing of tax deductions for share-based payments is dictated by the acquisition of the shares by employees and the amount of the deduction is broadly the market value at the time of acquisition less the amount paid by the employee. The tax base for charges recognised in the accounts should be calculated as detailed in Section 6.



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