Chapter 18

IAS 12 INCOME TAXES

- current tax should normally be recognised in the Statement of Profit or Loss and Other Comprehensive Income except when…
- ...it relates to a gain or loss which has been recognised initially in equity
- dividend income (and interest and other similar income) should be grossed up for withholding tax and…
- ...the tax charge for the year should be correspondingly increased
- income and expenses included in arriving at profit before tax are included on an accruals basis
- current tax should be calculated using tax rates and laws which have been enacted (or substantially enacted) by the date of the statement of financial position
- tax charge in the Statement of Profit or Loss and Other Comprehensive Income often bears little relationship to the profit before tax figure in the Statement of Profit or Loss and Other Comprehensive Income
- profit before tax figure is adjusted to bring it into line with tax rules (as distinct from accounting rules)
- the differences between these two sets of rules may be permanent differences or temporary differences

IAS 12 differences in greater detail and deferred tax

- permanent differences arise where certain items included within the Statement of Profit or Loss and Other Comprehensive Income are either not taxable or not allowable for tax
- an example – entertaining expenditure
- temporary differences arise where there are differences between the carrying value of assets or liabilities in the statement of financial position compared with their value for tax purposes (their tax base or tax written-down value)
- deferred tax is the tax attributable to these temporary differences
- temporary differences may be taxable or deductible
- taxable temporary differences give rise to a deferred tax liability payable in the future
- deductible temporary differences give rise to a deferred tax asset in the future.

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IAS 12 Temporary differences

- taxable temporary differences can be short-term differences or long-term differences, for example arising on the revaluation of assets
- timing differences arise where financial statements items are taxable, but are recognised for tax reasons in periods other than the financial statements period
- for example, interest received is included in financial statements on an accruals basis but …
- … for tax purposes it is recognised on a cash / receipts basis
- the temporary difference is the difference between interest recognised in the Statement of Profit or Loss and Other Comprehensive Income and interest actually received

Example 1 - royalty income

Jurgita's profit from operations before royalty income is $700,000 per annum. In 2009 she was entitled to a one off royalty receipt of $60,000, which she eventually received in 2010.
Income tax is 25%
Extracts from Statement of Profit or Loss and Other Comprehensive Income

	2009	*2010*
	$'000	*$'000*
Profit from operations	700	700
Royalty receivable	60	-
	760	700
Income tax @ 25% on taxable profits	(175)	(190)
Profit after tax	585	510

Taxable profits

	$'000	*$'000*
Profit from operations	700	700
Royalty received	-	60
	700	760
Income tax @ 25%	175	190

Show how the entity provides for deferred tax on the temporary timing difference.

IAS 12 Temporary differences continued

- a temporary difference also arises where the capital allowances rate (or tax depreciation rate) differs from the accounting deprecation rate applied to the same asset

Example 2

Andris buys an asset on 1 January, 2009 for $600,000.
It has a useful life of three years and is scrapped at the end of its life.

	2009	*2010*	*2011*
	$'000	*$'000*	*$'000*
Profits before depreciation	1,800	2,300	2,500

A first year tax allowance of 100% is available on this asset.
The tax rate for Andris is 25%

Show how Andris should provide for deferred tax on the temporary timing difference.

- another time that temporary difference arises is following a revaluation of asset

- the difference is the difference between the asset's revalued amount and its tax written-down value

- because the revaluation increase is credited direct to equity, the associated deferred tax should also be charged to equity, and therefore is not included as part of the tax charge for the year in the Statement of Profit or Loss and Other Comprehensive Income

Example 3

Aija purchased a property on 1 January 1998 for $450,000. On 31 December, 2009 the property has a net book value of $342,000 and was revalued to $600,000. The tax written down value was $450,000.
Income tax rate is 25%

Calculate the figure for the Revaluation Reserve as at 31 December, 2009.

IAS 12 deductible temporary differences

- less common than taxable temporary differences
- give rise to a deferred tax asset on the statement of financial position

Example 4

Ilze has a profit from operations of $660,000 per annum (before warranty provision). In 2009 she recognises a liability of $160,000 for accrued product warranty costs. For tax purposes the warranties will not be deductible until the entity pays them. $160,000 of claims are paid in 2010
Income tax is 25%

Extracts from Statement of Profit or Loss and Other Comprehensive Income

	2009	*2010*
	$'000	*$'000*
Profit from operations	660	660
Warranties	(160)	-
	500	660
Income tax @ 25% on taxable profits	165	125
Profit after tax	335	535

Taxable profits

Profit from operations	660	660
Warranty payments made	-	(160)
	660	500
Income tax @ 25%	165	125

The entity wishes to provide for deferred tax on the temporary difference.

- IAS 12 requires the use of the "full provision" method whereby temporary differences are provided for in full

- based on the principle that the financial statements for a period should recognise the tax effects of all transactions occurring in that period

- deferred tax assets and liabilities should be calculated using tax rates which are expected to apply in the period when the asset is realised or the liability is settled

Reasons for recognising deferred tax and related disclosure requirements

- **reasons for recognising deferred tax:**

  - accruals concept requires it

  - deferred tax will become a liability eventually

  - if not recognised, overstatement of profit could lead to:

    - over-optimistic dividend payments
    - distorted earnings per share figure (and P/E ratio) will mislead stake-holders
    - share-holders will be under-informed

- **disclosure**

  - masses of disclosure requirements include:

    - current tax expense
    - adjustments recognised this year to the tax charges from previous periods
    - tax relating to items charged direct to equity
    - details of deferred tax asset / liability broken down by type of temporary difference
    - reconciliation between accounting profit and taxable profit

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