2009

IFRS Foundation: Training Material for the *IFRS® for SMEs*

Module 29 – Income Tax

IFRS™

IFRS Foundation: Training Material for the *IFRS® for SMEs*

including the full text of
Section 29 *Income Tax*
of the International Financial Reporting Standard (IFRS)
for Small and Medium-sized Entities (SMEs)
issued by the International Accounting Standards Board on 9 July 2009

with extensive explanations, self-assessment questions and case studies

IFRS Foundation®
30 Cannon Street
London EC4M 6XH
United Kingdom

Telephone: +44 (0)20 7246 6410
Fax: +44 (0)20 7246 6411
Email:info@ifrs.org

Publications Telephone: +44 (0)20 7332 2730
Publications Fax: +44 (0)20 7332 2749
Publications Email: publications@ifrs.org
Web: www.ifrs.org

This training material has been prepared by IFRS Foundation education staff. It has not been approved by the International Accounting Standards Board (IASB). The training material is designed to assist those training others to implement and consistently apply the *IFRS for SMEs*. For more information about the IFRS education initiative visit http://www.ifrs.org/Use+around+the+world/Education/Education.htm.

IFRS Foundation®
30 Cannon Street | London EC4M 6XH | United Kingdom
Telephone: +44 (0)20 7246 6410 | Fax: +44 (0)20 7246 6411
Email: info@ifrs.org Web: ww.ifrs.org

Right of use

Although the IFRS Foundation encourages you to use this training material, as a whole or in part, for educational purposes, you must do so in accordance with the copyright terms below.

Please note that the use of this module of training material is not subject to the payment of a fee.

Copyright notice

Please address publication and copyright matters to:
IFRS Foundation Publications Department
30 Cannon Street London EC4M 6XH United Kingdom
Telephone: +44 (0)20 7332 2730 Fax: +44 (0)20 7332 2749
Email: publications@ifrs.org Web: www.ifrs.org

Contents

Module 29 – Income Tax

This training material has been prepared by IFRS Foundation education staff and has not been approved by the International Accounting Standards Board (IASB).
The accounting requirements applicable to small and medium-sized entities (SMEs) are set out in the *International Financial Reporting Standard (IFRS) for SMEs*, which was issued by the IASB in July 2009.

INTRODUCTION

This module focuses on the accounting and reporting of income tax in accordance with Section 29 *Income Tax* of the *IFRS for SMEs*. It introduces you to the subject, guides you through the official text, develops your understanding of the requirements through the use of examples and indicates significant judgements that are required in accounting for income tax. Furthermore, the module includes questions designed to test your knowledge of the requirements and case studies to develop your ability to account for income tax in accordance with the *IFRS for SMEs*.

Learning objectives

Upon successful completion of this module you should know the financial reporting requirements for income tax in accordance with the *IFRS for SMEs*. Furthermore, through the completion of case studies that simulate aspects of the real world application of that knowledge, you should have enhanced your competence to account for income tax in accordance with the *IFRS for SMEs*. In particular you should, in the context of the *IFRS for SMEs*, be able to:

- determine whether a tax is an income tax
- recognise and measure any current tax assets and liabilities
- identify the assets and liabilities that would be expected to affect taxable profit if they were recovered or settled for their present carrying amounts
- determine the tax basis of assets, liabilities and other items that have a tax basis although they are not recognised as assets or liabilities
- identify and compute temporary differences, unused tax losses and unused tax credits
- recognise and measure deferred tax assets and liabilities
- assess when it is necessary to recognise a valuation allowance against a deferred tax asset
- ascertain which tax rates and tax laws should be used in the measurement of current and deferred tax assets and liabilities
- allocate current and deferred tax to the related components of comprehensive income and equity
- identify when current tax assets and current tax liabilities, and deferred tax assets and deferred tax liabilities, can be offset
- present and disclose income tax in financial statements
- demonstrate an understanding of significant estimates and other judgements that are required in accounting for income tax.

Module 29 – Income Tax

IFRS for SMEs

The *IFRS for SMEs* is intended to apply to the general purpose financial statements of entities that do not have public accountability (see Section 1 *Small and Medium-sized Entities*).

The *IFRS for SMEs* includes mandatory requirements and other material (non-mandatory) that is published with it.

The material that is not mandatory includes:

- a preface, which provides a general introduction to the *IFRS for SMEs* and explains its purpose, structure and authority.
- implementation guidance, which includes illustrative financial statements and a disclosure checklist.
- the Basis for Conclusions, which summarises the IASB's main considerations in reaching its conclusions in the *IFRS for SMEs*.
- the dissenting opinion of an IASB member who did not agree with the publication of the *IFRS for SMEs*.

In the *IFRS for SMEs* the Glossary is part of the mandatory requirements.

In the *IFRS for SMEs* there are appendices in Section 21 *Provisions and Contingencies*, Section 22 *Liabilities and Equity* and Section 23 *Revenue.* Those appendices are non-mandatory guidance.

Introduction to the requirements

The objective of general purpose financial statements of a small or medium-sized entity is to provide information about the entity's financial position, performance and cash flows that is useful for economic decision-making by a broad range of users who are not in a position to demand reports tailored to meet their particular information needs. The objective of Section 29 is to prescribe the accounting and reporting requirements for income tax. Income tax includes all domestic and foreign taxes that are based on taxable profits. It also includes taxes, such as withholding taxes, that are payable by a subsidiary, associate or joint venture on distributions to the reporting entity.

Current tax

Current tax is the amount of income tax payable or recoverable in respect of the taxable profit for the current period or past reporting periods. An entity shall recognise a current tax liability for current tax payable. If the amount paid exceeds the amount due, the entity recognises a current tax asset.

An entity measures current tax using the applicable tax law and rates enacted or substantively enacted, at the reporting date, including the effect of the possible outcomes of a review by the tax authorities.

Deferred tax

Deferred tax assets and liabilities are recognised for income tax expected to be recoverable or

payable in respect of the taxable profit for future reporting periods because of past transactions or events. Deferred tax arises from the difference between the amounts recognised for the entity's assets and liabilities in the statement of financial position and the recognition of those assets and liabilities by the tax authorities, and the carryforward of currently unused tax losses and tax credits.

Deferred tax assets and liabilities are measured at an amount that includes the effect of the possible outcomes of a review by the tax authorities using tax rates that, on the basis of enacted or substantively enacted tax law at the end of the reporting period, are expected to apply when the deferred tax asset is realised or the deferred tax liability is settled. A valuation allowance is recognised against deferred tax assets so that the net amount equals the highest amount that is more likely than not to be realised on the basis of current or future taxable profit.

Presentation and disclosure of current and deferred tax

Current and deferred tax is allocated to the related components of profit or loss, other comprehensive income and equity.

Current and deferred tax assets and liabilities are not discounted.

Section 29 requires an entity to provide specified disclosures about current and deferred tax.

Module 29 – Income Tax

REQUIREMENTS AND EXAMPLES

The contents of Section 29 *Income Tax* of the *IFRS for SMEs* are set out below and shaded grey. Terms defined in the Glossary of the *IFRS for SMEs* are also part of the requirements. They are in **bold type** the first time they appear in the text of Section 29. The notes and examples inserted by the IFRS Foundation education staff are not shaded. Other annotations inserted by the IFRS Foundation staff are presented within square brackets in ***bold italics***. The insertions made by the staff do not form part of the *IFRS for SMEs* and have not been approved by the IASB.

Scope of this section

29.1 For the purpose of this IFRS, **income tax** includes all domestic and foreign taxes that are based on **taxable profit**. Income tax also includes taxes, such as withholding taxes, that are payable by a subsidiary, associate or joint venture on distributions to the reporting entity.

Notes

How do entities determine whether a tax is an income tax?

Income taxes are charged by tax authorities on the income earned by entities and individuals. In this context, income is a net amount reflecting taxable revenue minus tax-deductible expenses. Paragraph 29.1 defines income tax for the purposes of Section 29. Taxable profit (or tax loss) is the profit (loss) for a reporting period upon which income taxes are payable or recoverable, determined in accordance with the rules established by the taxation authorities (government bodies). Taxable profit equals taxable income less amounts deductible from taxable income. The tax rate (ie the percentage applied to the taxable profit in order to calculate the tax charge for the year) is also governed by those rules.

Section 29 applies to income taxes, which are defined as taxes that are based on taxable profit. Hence, not all taxes will fall within the scope of Section 29. However, because taxable profit is not the same as accounting profit, taxes do not need to be based on a figure that is exactly accounting profit to be within the scope of Section 29. Taxable profit is often not the same as profit or loss or total comprehensive income.
The determination of whether or not a tax is an 'income tax' sometimes requires judgement, based on the specific facts and circumstances.

Are tax benefits within the scope of Section 29?

Section 24 *Government Grants* specifies the accounting for all government grants. Consequently, government grants are not accounted for under Section 29. However, paragraph 24.3 specifically notes that Section 24:

'does not cover government assistance that is provided for an entity in the form of benefits that are available in determining taxable profit or tax loss, or are determined or limited on the basis of income tax liability. Examples of such benefits are income tax holidays, investment tax credits, accelerated depreciation allowances and reduced income tax rates. Section 29 Income Tax *covers accounting for taxes based on income'.*

Accelerated depreciation allowances accelerate the rate at which the cost of a new item of property, plant and equipment is written off against taxable income (ie the allowances mean that the asset is depreciated at a faster rate for tax purposes than the rate of depreciation charged in the financial statements for financial reporting purposes). The effect is to reduce taxable income (and thereby reduce income tax) in earlier periods (as illustrated in example 2). Section 29 covers the accounting for such income tax effects.

Example – tax which is not income tax under Section 29

Ex 1 **The following are types of taxes that would not be accounted for as income tax in accordance with Section 29 because they are not based on taxable profits:**

- **Sales taxes, because they are based on sales value (a gross amount) rather than on taxable profits (eg tax based on total sales value from sale of alcohol or cigarettes).**
- **Consumption taxes such as value added tax (VAT), or goods and services tax (GST), which are taxes levied on any value that is added to a product.**
- **Some production taxes may not meet the definition of income tax depending upon the specific terms (eg a tax imposed on mining companies for each unit mined (based on an individual item)).**
- **Taxes payable on employee benefits paid (eg social security taxes payable based on a percentage of employee's wages). Such tax would be accounted for under Section 28 *Employee Benefits*.**
- **Stamp duty, a form of tax that is levied on documents.**

29.2 This section covers accounting for income tax. It requires an entity to recognise the current and future tax consequences of transactions and other events that have been recognised in the financial statements. These recognised tax amounts comprise **current tax** and **deferred tax**. Current tax is tax payable (refundable) in respect of the taxable profit (tax loss) for the current period or past periods. Deferred tax is tax payable or recoverable in future periods, generally as a result of the entity recovering or settling its **assets** and **liabilities** for their current carrying amount, and the tax effect of the carryforward of currently unused tax losses and tax credits.

Notes

Overall approach for income tax (and why)

Section 29 requires two calculations for income tax at the end of the reporting period:

- The calculation of the current tax expense (or income)—the amount of income tax payable (or recoverable) for the current period and adjustments relating to current tax for prior periods.
- The calculation of the deferred tax expense (income)—the amount arising from recognising new deferred tax assets and liabilities, and recognising changes in existing deferred tax assets and liabilities.

If accounting profits (ie profits in the income statement or statement of comprehensive income) were always equal to taxable profits (ie, profits upon which income tax is payable) and both types of profits were always determined using the same rules, then accounting for income tax would be straightforward. It would involve calculating the amount payable by applying the tax rate to accounting profits, recognising a liability and an expense for that amount payable and later recording the eventual payment on settlement of the liability.

However, taxable profits of a particular period often differ, sometimes significantly, from accounting profits. This is because tax laws in different jurisdictions differ from the *IFRS for SMEs* in their recognition and measurement of income, expenses, assets and liabilities. Consequently, the tax expense cannot simply be determined by multiplying accounting profits by the tax rate. Instead, accounting for income taxes involves identifying and accounting for the differences between accounting profit and taxable profit, and identifying the differences between assets and liabilities recognised in the financial statements and how those assets and liabilities are measured under tax laws.

It is inherent in the recognition of an asset or liability that the reporting entity expects to recover or settle the carrying amount of that asset (see paragraph 2.37) or liability (see paragraph 2.39). If it is probable that recovery or settlement of that carrying amount will make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences, then an entity recognises a deferred tax liability (deferred tax asset). This provides useful information for users of an entity's financial statements.

The following simple example illustrates the calculation of current tax and deferred tax.

Example – deferred tax arising because of accelerated tax depreciation

Ex 2 **The only difference between an entity's accounting profit and its taxable profit arises from the laws permitting the cost of a particular type of machinery with a useful life of three years to be fully deductible for tax purposes in the year of purchase. For financial reporting purposes, the entity depreciates the machine on a straight-line basis over three years to a nil residual value. The entity acquired the machine for CU600 on 1 January 20X1. Its accounting profit is CU1,000 for each of the years 20X1–20X3. The entity incurs income tax at the rate of 30 per cent of its taxable profit.**

The entity calculates current tax as follows:

		20X1	*20X2*	*20X3*	*Cumulative 20X1–20X3*
	Calculation	*CU*	*CU*	*CU*	*CU*
Accounting profit		1,000	1,000	1,000	3,000
Add back accounting depreciation	CU600 ÷ 3 years	200	200	200	600
Deduct tax depreciation		(600)	–	–	(600)
Taxable profit		600	1,200	1,200	3,000
Current tax expense	30% × taxable profit	180	360	360	900

The entity calculates deferred tax on the machine as follows:

		20X1	*20X2*	*20X3*
	Calculation	*CU*	*CU*	*CU*
Carrying amount	CU600 less CU200 depreciation per year	400	200	–
Tax basis (ie future tax deductions)	nil as CU600 all deducted in 20X1	–	–	–
Temporary difference (in this example, also a timing difference)		400	200	–
Deferred tax liability	30% × temporary difference	120	60	–
Deferred tax expense/(income)	change in the deferred tax liability for the period	120	(60)	(60)

The entity's income tax expense would be presented in its statement of comprehensive income or income statement or statement of income and retained earnings as follows:

		20X3	*20X2*	*20X1*
	Calculation	*CU*	*CU*	*CU*
…				
Profit before tax	accounting profit	1,000	1,000	1,000
Income tax expense	current tax + deferred tax	(300)	(300)	(300)
Profit for the year		700	700	700

Notes:

The temporary difference (accelerated tax allowance) in this example is a difference in the timing of expense recognition for accounting and tax purposes (sometimes referred to as a timing difference)—the expenses recognised in profit or loss in one period (ie CU200 per year in 20X1–20X3) is, under the tax laws, included in taxable income (profit) in a different period (ie CU600 in 20X1). The total amount included in accounting profit (CU600) and taxable profit is the same over the three-year period.

By recognising a deferred tax liability in respect of the temporary difference, the entity's tax expense reflects the temporary nature of the accelerated tax allowance. Accordingly, in this simple example total tax expense (ie current tax expense + deferred tax expense equals 30 per cent × CU1,000 accounting profit in each year—20X1–20X3).

Steps in accounting for income tax

29.3 An entity shall account for income tax by following the steps (a)–(i) below:

(a) recognise current tax, measured at an amount that includes the effect of the possible outcomes of a review by the tax authorities (paragraphs 29.4–29.8).

(b) identify which assets and liabilities would be expected to affect taxable profit if they were recovered or settled for their present carrying amounts (paragraphs 29.9 and 29.10).

(c) determine the **tax basis** of the following at the end of the **reporting period**:

(i) the assets and liabilities in (b). The tax basis of assets and liabilities is determined by the consequences of the sale of the assets or settlement of liabilities for their present carrying amounts (paragraphs 29.11 and 29.12).

(ii) other items that have a tax basis although they are not recognised as assets or liabilities, ie items recognised as income or expense that will become taxable or tax-deductible in future periods (paragraph 29.13).

(d) compute any **temporary differences**, unused tax losses and unused tax credits (paragraph 29.14).

(e) recognise **deferred tax assets** and **deferred tax liabilities** arising from the temporary differences, unused tax losses and unused tax credits (paragraphs 29.15–29.17).

(f) measure deferred tax assets and liabilities at an amount that includes the effect of the possible outcomes of a review by the tax authorities using tax rates that, on the basis of enacted or substantively enacted tax law at the end of the reporting period, are expected to apply when the deferred tax asset is realised or the deferred tax liability is settled (paragraphs 29.18–29.25).

(g) recognise a valuation allowance against deferred tax assets so that the net amount equals the highest amount that is more likely than not to be realised on the basis of current or future taxable profit (paragraphs 29.21 and 29.22).

(h) allocate current and deferred tax to the related components of **profit or loss, other comprehensive income** and **equity** (paragraph 29.27).

(i) present and disclose the required information (paragraphs 29.28–29.32).

Recognition and measurement of current tax

29.4 An entity shall recognise a current tax liability for tax payable on taxable profit for the current and past periods. If the amount paid for the current and past periods exceeds the amount payable for those periods, the entity shall recognise the excess as a current tax asset.

Notes

Current tax is the amount of income tax payable (or refundable) in respect of the taxable profit (or tax loss) for the current period or past reporting periods. The current tax expense for the year is based on the taxable and deductible amounts that are reported on the tax return for the current year.

Occasionally, there is uncertainty over whether the tax authority will accept the

amounts that the entity reports to it as income or deductions. Hence, the actual amount that is paid some time later may be different from the initial estimate determined under this section (see paragraph 29.24). In this case the entity will have made either an over-provision or under-provision for current tax.

If an over-provision or under-provision for current tax is identified before the financial statements are authorised for issue, the current tax expense/liability will be adjusted. This is an example of an adjusting event under Section 32 *Events after the End of the Reporting Period*.

If an over-provision or under-provision for current tax is identified after the financial statements are authorised for issue, it would, in accordance with Section 10 *Accounting Policies, Estimates and Errors* be accounted for as a change in accounting estimate (see paragraphs 10.15-10.17) or as a prior period error (see paragraphs 10.19-10.22). The facts and circumstances that resulted in the prior period over-provision or under-provision determine which accounting treatment is appropriate (ie it is not a 'free' choice).

The amounts should only be adjusted retrospectively if an error was made and the error led to a material misstatement. An error may arise if management of the entity has made a mistake, for example applying the tax rules from the wrong year or using the tax rules that apply to a completely different item. Module 10 *Accounting Policies, Estimates and Errors* provides guidance on accounting for changes in accounting estimates and prior period errors. If no material error was made, the revised estimate is, in accordance with paragraphs 10.15–10.17, usually accounted for through profit or loss of the period in which the estimate is revised as an adjustment of the current tax liability or asset.

Example – calculating current tax

Ex 3 **An entity has a year-end of 31 March. The tax year in the jurisdiction runs from 1 April to 31 March. The relevant income tax rate for 20X7/20X8 is 15 per cent. The entity has an accounting profit of CU150,000 for the year ended 31 March 20X8. The rules determining the determination of taxable profit in the jurisdiction are identical to the *IFRS for SMEs* for the year ended 31 March 20X8, except for the following income and expenses:**

- **CU20,000 royalty revenue recognised in 20X8 is exempt from income tax.**
- **No tax deduction is permitted for entertainment expenses of CU5,000.**
- **No tax deduction for bad debts is allowed until the debtors are derecognised from the financial statements. On 31 March 20X7, CU2,000 of debts were derecognised from the financial statements because the entity waived payment from one of the customers who was suffering financial difficulty. The bad debt provision, which is offset against trade receivables, was CU4,000 and CU4,500 on 31 March 20X7 and 31 March 20X8 respectively. Consequently, the bad debt expense for the year ended 31 March 20X8 was CU2,500 – comprising the debts written off and the increase in the provision.**
- **The building is depreciated at a faster rate for tax purposes. The amount of tax depreciation deductible in the year ended 20X8 was CU43,000. The amount of accounting depreciation in the financial statements for the same building for the year was CU35,000.**

Taxable profit could be estimated as follows:

Accounting profit for the year ended 31 March 20X8	CU150,000
Less royalty revenue not taxable	(CU20,000)
Plus entertainment expenses not deductible	CU5,000
Plus increase in bad debt allowance not deductible (ie CU4,500 less CU4,000)	CU500
Less additional depreciation deductible (ie CU43,000 less CU35,000)	(CU8,000)
Taxable profit	CU127,500
Current tax expense for the year ended 31 March 20X8 (CU127,500 × 15%)	CU19,125

Note: the deferred tax impact of the transactions above is ignored in this question.

Examples – recognising and adjusting current tax expense for the year

Ex 4 **An entity calculates its taxable profit to be CU100,000 for the tax year 20X7/20X8 determined in accordance with the relevant tax rules in its jurisdiction. The tax year in the jurisdiction runs from 1 April to 31 March. The appropriate income tax rate for 20X7/20X8 is 20 per cent. The current tax payable for the tax year 20X7/20X8 is payable by 30 September 20X8 and the entity makes the payment on 15 September 20X8. The entity has a 31 March financial year end (end of the reporting period).**

The entity could recognise the current tax payable for the year ended 31 March 20X8 as follows:

Dr	Profit or loss—income tax (current tax)	CU20,000[(a)]	
	Cr Current tax liability		CU20,000

To recognise current tax liability and expense.

(a) CU100,000 × 20% = CU20,000

Note: this expense arises over the year, but assuming that the entity only reports on 31 March 20X8, the expense may be recorded in full on the reporting date.

On 15 September 20X8 the entity could recognise the payment of income tax for the year ended 31 March 20X9 as follows:

Dr	Current tax liability	CU20,000	
	Cr Cash		CU20,000

To recognise the settlement of current tax liability.

Ex 5 **The facts are the same as in example 4. However, on 1 June 20X8, before the financial statements are authorised for issue, the entity recalculates its taxable profit to be CU95,000 owing to new information arising between 31 March and 1 June 20X8 that provides evidence of conditions that existed at 31 March 20X8 (eg because the amount of profit-sharing payments to employees for the year ended 31 March 20X8, which had originally been estimated, is now finalised).**

The entity would recognise current tax expense for year ended 31 March 20X8 at CU19,000[(a)] and, at 31 March 20X8, a liability for current taxes payable at CU19,000 (ie an adjusting event after the end of the reporting period in accordance with Section 32 *Events after the End of the Reporting Period*).

The entity would recognise the following journal entries to correct the original estimate of current tax payable for the year ended 31 March 20X8:

Dr	Current tax liability	CU1,000[(b)]	
	Cr Income tax expense (current tax)		CU1,000

On 15 September 20X8 the entity would make the following journal entries for the year ended 31 March 20X9 to recognise the payment of tax:

Dr	Current tax liability	CU19,000	
	Cr Cash		CU19,000

(a) CU95,000 × 20% = CU19,000

(b) CU20,000 original estimate less (CU95,000 × 20% = CU19,000) = CU1,000 adjustment

Ex 6 **In entity A's jurisdiction the tax year runs from 1 July to 30 June. All companies are required to pay a provisional amount of tax to the tax authorities three month before the end of the tax year (by 1 April) based on taxable profits for the prior year. The tax rate from 20X1 to the current date is 30 per cent.**

Entity A has a 30 June financial year end (end of reporting period). For the year ended 30 June 20X4, entity A had taxable profits of CU50,000. Consequently, the actual tax payable for 20X3/20X4 was CU15,000. On the basis of this amount, entity A made a provisional tax payment of CU15,000 to the tax authority on 1 April 20X5 as the best estimate of tax payable for 20X4/20X5.

Before entity A's 30 June 20X5 financial statements are authorised for issue, its actual taxable profit for the year ended 30 June 20X5 is estimated at CU40,000.

The entity would recognise current tax for the year ended 30 June 20X5 at CU12,000.[(a)] At 30 June 20X5 the entity has an asset for the overpayment of tax (ie a refund due from the tax authorities) of CU3,000[(b)].

On 1 April 20X4 the entity could make the following journal entries to recognise the payment of tax:

Dr	Current tax asset	CU15,000	
	Cr Cash		CU15,000

The entity should recognise the following journal entries to recognise its estimated current tax payable for the year ended 30 June 20X4:

Dr	Income tax expense (current tax)	CU12,000[(c)]	
	Cr Current tax liability		CU12,000

(a) CU40,000 × 30% = CU12,000

(b) CU15,000 less CU12,000 = CU3,000

(c) CU40,000 × 30% = CU12,000

29.5 An entity shall recognise a current tax asset for the benefit of a tax loss that can be carried back to recover tax paid in a previous period.

Notes

A tax loss arises in an accounting period in which taxable 'profit' is negative (ie allowable deductions exceed the income that is taxable). Some tax laws allow entities to use a loss in one year to offset a profit in one or more prior years (called a tax loss carryback). When a tax loss is used to recover current tax for a previous period, an entity recognises the benefit as an asset in the period in which the tax loss occurs, because it is probable that the benefit will flow to the entity and the benefit can be reliably measured.

If the entity is unable to carryback the tax loss, for example, if it is not permitted by rules in the jurisdiction or the entity does not have enough profits in prior years to offset the entire loss, the entity may be able to carry the tax loss forward with or without a time limit and set the loss against taxable income in a future period. (See paragraph 29.15 regarding the recognition of a deferred tax asset for carryforward of unused tax losses.)

If the entity is unable to carry forward or carry back the loss, the loss is not usable and so no asset is recognised.

Examples – tax loss carryback

Ex 7 **In accordance with the relevant tax rules in its jurisdiction, an entity estimates its taxable loss for the tax period 20X7/20X8 at CU9,000. The tax legislation in the jurisdiction permits entities to carry back losses three tax years into the past with no requirement on which of the three years the loss is set off against first. Taxable income in 20X6/20X7 was CU7,000, in 20X5/20X6 it was CU5,000 and in 20X4/20X5 it was CU3,000. The entity has a 30 September financial year-end (end of the reporting period) and this coincides with the entity's tax year.**

The relevant income tax rates are as follows:

- **18 per cent in 20X6/20X7 and 20X7/20X8**
- **20 per cent in 20X5/20X6**
- **17 per cent in 20X4/20X5.**

The entity will want to maximise the refund. Consequently, the entity first would set off the losses against the prior year that has the highest tax rate. Hence, the entity would carry back CU5,000 of the loss to 20X5/20X6 (the maximum possible, because the amount cannot exceed available profits) and CU4,000 to 20X6/20X7. As a result, the entity will save tax at 20 per cent on the CU5,000 carried back to 20X5/20X6 and save tax at 18 per cent on the CU4,000 carried back to 20X6/20X7.

The tax refund is CU1,720 (ie CU5,000 × 20% + (CU4,000 × 18%)).

For the year ended 30 September 20X8, the entity would recognise a current tax asset/benefit as follows:

Dr	Current tax asset	CU1,720	
	Cr Profit or loss—income tax (current tax)		CU1,720

To recognise current tax asset.

Ex 8 **The facts are the same as in example 7. However, in this example, the tax laws require the entity to set the losses against the most recent period possible, ie 20X6/20X7 first, 20X5/20X6 second and 20X4/20X5 last.**

The entity must first set off the losses against 20X6/20X7. Consequently, the entity would carry back CU7,000 of the loss to 20X6/20X7 and CU2,000 to 20X5/20X6. As a result, the entity will save tax at 18 per cent on the CU7,000 carried back to 20X6/20X7 and at 20 per cent on CU2,000 in 20X5/20X6.

The tax refund is CU1,660 (ie CU7,000 × 18% + (CU2,000 × 20%)).

For the year ended 30 September 20X8, the entity would recognise a current tax asset/benefit as follows

Dr	Current tax asset	CU1,660	
	Cr Profit or loss—income tax (current tax)		CU1,660

To recognise current tax asset.

29.6 An entity shall measure a current tax liability (asset) at the amounts it expects to pay (recover) using the tax rates and laws that have been enacted or substantively enacted by the **reporting date**. An entity shall regard tax rates as substantively enacted when future events required by the enactment process historically have not affected the outcome and are unlikely to do so. Paragraphs 29.23–29.25 provide additional measurement guidance.

Notes

Often current tax assets and liabilities (and deferred tax assets and liabilities, see paragraph 29.11) are measured by reference to the tax rates and tax laws that have been enacted by the reporting date. Whether or not a tax rate or other law has been enacted by the end of the reporting period is a fact that should be easy to ascertain.

In some jurisdictions, actions by the government relating to tax rates and tax laws have the substantive effect of actual enactment, even though official enactment may be a formality that follows the actions by a period of several months. In this case the substantively-enacted rates or laws should be used, because it would be inappropriate to wait for formal enactment. When enactment is merely a formality, it is virtually certain that it will happen, so waiting for enactment would give undue weight to the act of enactment. For example, in some jurisdictions a formal government announcement of the changes may constitute substantive enactment. New tax rates or tax laws are substantively enacted when future events required by the enactment process historically have not affected the outcome and are unlikely to do so. (This does not mean that they cannot do so under any circumstances.) An entity may need to

apply judgement based on the specific facts and circumstances in considering whether or not actions by the government mean a change has been substantively enacted. For example: what are the remaining procedures, when are they likely to take place, and are they simply small, routine tasks or larger, unusual tasks? Where actions by the government, eg announcements of tax rates (and tax laws), are in substance equivalent to actual enactment, the announced tax rates (and tax laws) will be used for tax relating to the periods in which they will apply.

In other jurisdictions, it may be necessary for all (or close to all) of the legally-required steps towards enactment to have been completed before the new rates or laws can be regarded as substantively enacted. For example, in the US tax jurisdiction, substantive enactment is achieved only upon legal enactment. This is because the effect of the President's power of veto is that the point when any future steps in the enactment process will not change the outcome is always only at legal enactment (ie when the President has signed off the necessary legislation).

When paragraphs 29.6 (and 29.11) require that current tax assets and liabilities (and deferred tax assets and liabilities) are measured by reference to the tax rates and tax laws that have been enacted (or substantially enacted) by the reporting date, that does not mean the rates that apply to the taxable period ending at the reporting date. Rather, paragraphs 29.6 and 29.11 require use of the rates enacted (or substantially enacted) by the end of the reporting period that will be in effect at the time the temporary difference reverses.

Example – change in tax rates

Ex 9 **An entity operates in a jurisdiction where a change in tax rate from 25 per cent to 26 per cent was announced on 1 November 20X6 and will take effect from 1 April 20X7. The entity has a year end of 31 March. Assume that the announcement on 1 November 20X6 is considered substantive enactment.**

An entity shall measure its current tax liability using the tax rates and laws that have been enacted or substantively enacted by the reporting date.

The new tax rate of 26 per cent has been substantively enacted by the reporting date (31 March 20X7) so it should be used for tax relating to the periods in which that rate applies. However, current tax for the year ended 31 March 20X7 will be determined using the rate of 25 per cent because the new rate will apply only from 1 April 20X7 (although it will apply to the measurement of deferred tax). Current tax for the year ended 31 March 20X8 will be determined using the new rate of 26 per cent.

29.7 An entity shall recognise changes in a current tax liability or current tax asset as **tax expense** in profit or loss, except that a change attributable to an item of **income** or **expense** recognised under this IFRS as other comprehensive income shall also be recognised in other comprehensive income.

Notes

If an entity does not have any items of income or expense that are recognised outside profit or loss as other comprehensive income, then all changes in current tax assets and liabilities will be recognised in profit or loss unless they relate to an item recognised in equity (see paragraph 29.27).

Entities only need to address the allocation of the total tax expense (ie current tax plus deferred tax), because Section 29 does not require an analysis of total tax expense into current and deferred tax in either profit or loss, other comprehensive income or equity. In some cases, allocating current tax and deferred tax separately can be done only on an arbitrary basis.

Paragraph 5.4(b) notes that there are three types of income and expenses that may be recognised in other comprehensive income, outside of profit or loss, under the *IFRS for SMEs* when they arise:

- Some gains and losses arising on translating the financial statements of a foreign operation (see Section 30 *Foreign Currency Translation*)
- Some actuarial gains and losses depending on an entity's accounting policy for such gains and losses relating to defined benefit plans (see Section 28 *Employee Benefits*)
- Some changes in fair values of hedging instruments (see Section 12 *Other Financial Instruments Issues*).

A change in a current tax asset or liability attributable to one of the three items of income/expense above should be recognised in other comprehensive income if that income/expense is recognised in other comprehensive income.

Example – allocation

Ex 10 **Several years ago a parent entity, functional currency CU, made a loan in a foreign currency, FCU[(1)], to a foreign subsidiary. In 20X6 an exchange loss of CU10,000 arose on the loan. The loan is regarded by the parent as part of its net investment in the foreign subsidiary under Section 30 *Foreign Currency Translation* (see paragraph 30.13). Paragraph 30.13 requires such exchange differences to be recognised initially in other comprehensive income (OCI), and reported as a component of equity in the consolidated financial statements. The exchange loss is the only item in OCI in the parent's consolidated financial statements for 20X6. The exchange loss is tax deductible when incurred for financial reporting purposes (ie no deferred tax arises on the FCU loan).**

In the year ended 31 December 20X6 the group incurs taxable income of CU500,000 (after deducting the exchange loss). The tax rate for 20X6 is 20 per cent. All group entities have a 31 December 20X6 year end.

The current tax expense for 20X6 is CU100,000 (ie CU500,000 × 20%).

The tax saving related to the exchange loss is CU2,000 (ie CU10,000 × 20%).

(1) In this example, and in all other examples in this module, foreign currency monetary amounts are denominated in 'foreign currency units (FCU)'.

The tax expense is allocated as follows:

Current tax on accounting profit (balancing figure presented in profit or loss)	CU102,000
Current tax relief on exchange loss (presented in OCI)	(CU2,000)
Current tax expense	CU100,000

This is a situation where a change in a current tax liability or current tax asset can be allocated to other comprehensive income. In some other circumstances, allocating current tax separately from deferred tax may be more difficult (the notes supporting paragraph 29.17 deal with this in more detail). However, in this example there is no deferred tax on the FCU loan.

29.8 An entity shall include in the amounts recognised in accordance with paragraphs 29.4 and 29.5 the effect of the possible outcomes of a review by the tax authorities, measured in accordance with paragraph 29.24.

Example

Ex 11 **Using probability-weighted average amounts of all possible outcomes (assuming the tax authorities will review the amounts reported and have full knowledge of all information) an entity measured its current tax expense for the year ended 31 December 20X1 at CU1,880 (see example 105).**

In November 20X1 the entity paid CU1,000 to the taxing authority as a provisional tax payment for the year ended 31 December 20X1. The payment was made on the basis of the entity's estimate of its taxable profit for the year ended 31 December 20X1.

The entity's liability for current tax at 31 December 20X1 is measured at CU880 (CU1,880 expense less CU1,000 paid in 20X1).

Recognition of deferred tax

General recognition principle

29.9 An entity shall recognise a deferred tax asset or liability for tax recoverable or payable in future periods as a result of past transactions or events. Such tax arises from the difference between the amounts recognised for the entity's assets and liabilities in the statement of financial position and the recognition of those assets and liabilities by the tax authorities, and the carryforward of currently unused tax losses and tax credits.

Notes

The notes supporting paragraph 29.2 (see above) provide a short introduction to accounting for income tax and the rationale for accounting for deferred tax.
A deferred tax liability or asset should be recognised if the recovery of the carrying amount of an asset or the settlement of a liability will result in higher (or lower) tax

payments in the future than would be the case if that recovery or settlement were to have no tax consequences.

Paragraphs 29.3(b) to 29.3(i) summarise the deferred tax methodology involved in accounting for deferred tax liabilities and assets. The steps involved are set out below:

Step 1: Identify which assets and liabilities are expected to affect taxable profit if they were recovered or settled for their carrying amount.
Step 2; Determine the tax basis at the reporting date of all those assets and liabilities (and of other items that have a tax basis although not recognised as assets or liabilities in the financial statements).
Step 3: Compute any temporary differences, unused tax losses and unused tax credits.
Step 4: Recognise deferred tax assets and liabilities arising from the temporary differences, unused tax losses and unused tax credits.
Step 5: Measure deferred tax assets and liabilities at an amount that includes the effect of the possible outcomes of a review by the tax authorities, using rates that, on the basis of substantively enacted tax law at the end of the reporting period, are expected to apply when the deferred tax asset is realised or the deferred tax liability is settled.
Step 6: Recognise a valuation allowance against deferred tax assets so that the net amount equals the highest amount that is more likely than not to be realisable against taxable profit.
Step 7: Allocate deferred tax to the related components of comprehensive income and equity.
Step 8: Disclose the required information.

Assets and liabilities whose recovery or settlement will not affect taxable profit

29.10 If the entity expects to recover the carrying amount of an asset or settle the carrying amount of a liability without affecting taxable profit, no deferred tax arises in respect of the asset or liability. Therefore, paragraphs 29.11–29.17 apply only to assets and liabilities for which the entity expects the recovery or settlement of the carrying amount to affect taxable profit and to other items that have a tax basis.

Notes (step 1)

Step one in the deferred tax methodology is to identify which assets and liabilities are expected to affect taxable profit if they are recovered or settled for their carrying amount. In assessing the potential effect on taxable profit, it is the expected manner of recovery or settlement of the asset or liability that is considered; for example, whether

the manner of recovery of an asset is the sale to another party or is its use within the business.

The approach to accounting for deferred tax in Section 29 is based on the principle that an asset recorded in the financial statements will be realised, for its carrying amount, in the form of economic benefits that will flow to the entity in future periods. When such benefits flow to the entity, they give rise to amounts that may enter into the determination of taxable profits. In addition there may be amounts related to the asset that are allowed as a deduction in determining taxable profits in either the same or a different period. An exception to this will arise if the income generated by the asset is non-taxable, in which case both the future taxable amounts and the future deductible amounts relating to that asset are nil.

In reality, an entity will often generate economic benefits in excess of the carrying amount of an asset, via use of that asset to generate operating profits or through sale of that asset. For example, inventory will usually be sold for more than its carrying amount. However, Section 29 requires the assessment to be performed as if the benefits are equal to the carrying amount of the asset. In other words, Section 29 only considers the amounts already recorded in the financial statements. Consequently, unless the income generated by the asset is non-taxable, the future taxable amounts relating to an asset at the end of a reporting period will usually be the same as the asset's carrying amount.

Similarly, Section 29 looks at the future tax consequences of settling a liability at its carrying amount. Consequently, an entity is not required to estimate the amount that will be payable on settlement. For example, where a provision (such as a decommissioning liability) is recorded at a discounted amount, the future tax consequences of settling the liability at that discounted amount are considered, and not the tax consequences of settlement at the gross amount payable in the future. Another example would be where a settlement premium is being accrued over the life of a loan – the entity does not need to estimate the final settlement amount. Instead, it simply uses the current carrying amount at the reporting date. In the majority of situations, the future taxable amount of a liability is nil, because no part of the carrying amount of a liability (for example, a loan of CU1,000) would normally be taxable when the liability is settled.

Only those assets and liabilities that were identified in step one as those expected to affect taxable profit on recovery/settlement need to be considered when accounting for deferred tax. If there is expected to be no effect on taxable profit when an entity recovers or settles the carrying amount of an asset or a liability, then no deferred tax needs to be recognised in respect of that asset or liability. No further deferred tax calculation is required for that item (ie steps 2 to 8 in the deferred tax methodology (see notes below paragraph 29.9) can be ignored). This will happen when:

(a) no taxable income or amounts deductible from taxable income arise on the recovery or settlement of the carrying amount (see examples 12, 13 and 18 to 21); or

(b) equal taxable income and amounts deductible from taxable income arise, having a nil net effect (see examples 15 to 17); or

(c) a nil tax rate applies to any taxable or deductible amounts. In this case, although the recovery or settlement of the carrying amount may affect taxable profit, in practice the effect is the same as the situation described in (a) (see example 14).

In some tax jurisdictions, whether (a), (b) or (c) applies may depend on the manner in which the asset is recovered or the liability is settled. If an entity expects to recover the carrying amount of an asset, or settle the carrying amount of a liability, in a manner such that any one of paragraphs (a) to (c) applies, no deferred tax will be accounted for in respect of the asset or liability, because no deferred tax is expected to arise.

Example 34 illustrates a situation where, if the entity expects to recover an asset in one manner, no taxable income or amounts deductible from taxable income arise on the recovery of the carrying amount (paragraph (a) above), but if the entity expects to recover an asset in another manner, taxable income arises and therefore, in this scenario, deferred tax should be accounted for.

Paragraphs (a) to (c) above do not include the scenario where an entity expects to recover the carrying amount of an asset, or settle the carrying amount of a liability, in a period in which it expects to pay no current tax because of available unused tax losses. In such a scenario, if the entity expects the recovery or settlement of the carrying amount of an asset or liability to affect the amount of taxable profit in that period, a deferred tax asset or liability relating to the asset or liability may exist under the deferred tax methodology. Consequently, such assets and liabilities should be identified under paragraph 29.10. In other words, when applying paragraph 29.10, no assessment is carried out as to how likely it is that the amounts taxable or deductible will ultimately be deducted or taxed. This probability assessment is part of the analysis required for recognising a valuation allowance against a deferred tax asset under paragraphs 29.21 and 29.22 (step 6).

Examples – assets where recovery is not expected to affect taxable profit

Ex 12 **An entity has an amount receivable from a customer of CU5,000 that has no allowance for bad or doubtful debts set against it. The receipt of cash in settlement of the balance will have no tax consequences for the entity because the revenue has already been included in taxable income on sale of the goods or performance of the services.**

The expected manner of recovery of the asset (ie via the receipt of cash), does not affect taxable profit because no amounts are taxable or tax-deductible on receipt of the cash from the customer. Consequently, no deferred tax arises.

Ex 13 **An entity has dividends receivable from an investment in equity instruments in another entity. The dividends are not taxable when received—they were taxed in the period in which they were recognised in profit or loss.**

The expected manner of recovery of the asset (ie via the receipt of cash), does not affect taxable profit because no amounts are taxable or tax-deductible on receipt of the cash. Consequently, no deferred tax arises.

Ex 14 **An entity owns land that meets the definition of an investment property and is measured at fair value in accordance with Section 16 *Investment Property*. No tax is payable or recoverable on the proceeds of sale, because there is no capital gains tax in this jurisdiction and there are no other tax effects on sale such as clawback of tax deductions given during use of the asset.**

Because land is a non-depreciable asset (meaning that it would not be depreciated if it was accounted for under Section 17 *Property, Plant and Equipment* at cost), no part of its carrying amount is expected to be recovered (that is, consumed) through use. The entity expects to recover the carrying amount of the land through sale. No deferred tax will arise on recovery of the investment property, because a nil tax rate applies to any gain on sale and there are no other tax effects from sale.

Ex 15 **An entity holds an inventory of finished goods at cost. The inventories are deductible for tax purposes when they are sold. The deduction is equal to the cost of the inventories.**

The expected manner of recovery of the inventory (ie through sale), will not affect taxable profit because equal taxable income and amounts deductible from taxable income arise on recovery of the inventory, thus having a nil net effect.

- The taxable income from sale is assumed to be equal to carrying amount (ie cost). In reality, an entity will often generate economic benefits in excess of the carrying amount of the inventory on sale, because entities usually sell inventory at a profit. However, under Section 29 it is always assumed that the benefits are equal to the carrying amount of the asset (see notes under paragraph 29.10 above).
- The tax deduction on sale is also equal to the carrying amount of the inventory.

Ex 16 **An entity has machinery that is measured at depreciated cost. The machinery is deductible from taxable income either as the machinery is used (via tax depreciation) or, alternatively, on sale. Tax depreciation is applied on the same basis as depreciation for financial reporting purposes. Revenue generated by using the machine is taxable and any gain or loss on disposal of the machine will be taxable or deductible for tax purposes through a balancing adjustment (such as clawback of capital allowances claimed).**

Whether the machinery is recovered through sale or use (or a combination of both), it will not affect taxable profit, because equal taxable income and amounts deductible from taxable income arise on recovery of the machinery (both equal to the carrying amount of the machinery).

- Taxable income will arise either by sale of the machinery or by using the machinery to generate revenue (or using the machine for a while before selling it). In reality, on recovery of the asset, an entity will often generate economic benefits in excess of the carrying amount of the machinery, via a profit on sale or by helping to generate additional operating profits in excess of the carrying amount of the asset. However, Section 29 requires the assessment to be performed as if the benefits are equal to the carrying amount of the asset.
- Because tax depreciation is applied on the same basis as depreciation for financial reporting purposes, amounts deductible from taxable income on recovery of the asset (either through use or sale) are equal to the carrying amount of the machinery.

See example 23 for an illustration of when tax depreciation is on a different basis than depreciation for financial reporting purposes.

Ex 17 **An entity leases (as lessee) the office building that it occupies under an operating lease. It has an asset for a prepayment of six months of rent. Rents are tax-deductible at the time they are recognised for financial reporting purposes.**

In most cases such a prepayment will be recovered through use of the building. However, whether the prepaid rent is expected to be recovered through use of the building or by assignment of the lease through sale to another party, it will not affect taxable profit, because equal taxable income and amounts deductible from taxable income arise on recovery of the carrying amount.

- Taxable income arises on the recovery of the asset either via using the building to generate operating profits (which is expected to be the most likely use) or via proceeds on assignment of the lease. Section 29 requires the assessment to be performed as if the benefits are equal to the carrying amount of the asset.
- Because rent is tax deductible at the time of expense recognition, the carrying amount of the prepayment is tax-deductible as the asset is recovered.

Examples – liabilities where settlement is not expected to affect taxable profit

Ex 18 **An entity is required to pay fines and penalties because of having violated minor laws in the jurisdiction in the past year, such as late filing of accounts. The entity has recognised a liability for the fines and penalties that are payable. The fines are not deductible for tax purposes.**

No taxable income arises from fines payable. The fines are not amounts deductible from taxable income. Hence, the expected manner of settlement of the liability, via payment of the fines, does not affect taxable profit, so no deferred tax arises.

Ex 19 **An entity has a bank loan of CU50,000. Loan repayment will have no tax consequences.**

The expected manner of settlement of the liability, ie via the payment of cash, does not affect taxable profit, because no amounts are taxable or tax-deductible on repayment of the cash to the bank. Consequently, no deferred tax arises.

Ex 20 **An entity has an amount payable to a supplier of CU1,000. The repayment of the balance will have no tax consequences for the entity, because the expense has already been deducted from taxable income on receipt of the goods or services.**

The expected manner of settlement of the liability (ie via the payment of cash) does not affect taxable profit, because no amounts are taxable or tax-deductible on payment of the cash to the supplier. Consequently, no deferred tax arises.

Ex 21 **An entity has an amount payable to an employee of CU10,000 relating to services already rendered by the employee to the entity. The expense was tax-deductible when incurred (ie at the same time as expense recognition for financial reporting purposes).**

The expected manner of settlement of the liability (ie via the payment of cash) does not affect taxable profit, because no amounts are taxable or tax-deductible on payment of the cash to the employee. Consequently, no deferred tax arises.

Examples – assets where recovery is expected to affect taxable profit (ie they should need to be identified under paragraph 29.10)

Ex 22 **An entity has an asset of CU1,000 for interest receivable on a floating rate bank deposit. The interest will be taxed when cash is received.**

The expected manner of recovery of the asset (ie via the receipt of cash) affects taxable profit, because the amount is taxable when received. No amounts are tax-deductible on recovery of the asset. Consequently, deferred tax arises and must be accounted for.

Ex 23 **An entity has machinery that is measured at depreciated cost. The machinery is deductible from taxable income either as the machinery is used (via tax depreciation) or, alternatively, on sale. Tax depreciation is applied on a faster basis than depreciation for financial reporting purposes. Revenue generated by using the machine is taxable. If the asset is sold, deductions of 100 per cent of cost are available, but all previous deductions received for use must be returned (ie a clawback of all previous deductions). The machine was purchased three years ago and is being depreciated for financial reporting purposes over ten years.**

Whether the machinery is recovered through sale or use (or through a combination of both), it will affect taxable profit, because the amount deductible from taxable income is smaller than the taxable income deemed to arise on recovery of the machinery because of the faster tax depreciation rate.

Taxable income will arise either on sale of the machinery or by using the machinery to generate revenue. Section 29 requires the assessment to be performed as if the benefits are equal to the carrying amount of the asset.

Because tax depreciation is applied on a faster basis than depreciation for financial reporting purposes, the amount deductible from taxable income will be less than the carrying amount of the machinery. For example, assume that an item of machinery has a cost of CU100, and that so far CU30 of depreciation has been applied for financial reporting purposes. Further assume, for tax purposes, that depreciation of CU40 has been deducted in the current and prior periods, and that the remaining cost will be tax-deductible in future periods either as depreciation or through a deduction on disposal. The machinery has a carrying amount of CU70 (ie CU100 less CU30) and the future amount deductible from taxable income is CU60 (ie CU100 less CU40).

Note: if, on the other hand, depreciation for financial reporting purposes was applied on a faster basis than tax depreciation, the amounts deductible from taxable income will be greater than the carrying amount of the machinery. When the machinery is recovered, taxable profit will be affected because the amount deductible from taxable income is larger than the taxable income deemed to arise on recovery of the machinery.

See example 16 for an illustration of when tax depreciation is on the same basis as depreciation for financial reporting purposes.

Ex 24 **An entity leases its office building under an operating lease. It has an asset for CU6,000 equal to a prepayment of six months of rent. Rents are tax-deductible when they are paid to the landlord.**

In most cases such a prepayment will be recovered through use of the building. However, whether the prepaid rent is expected to be recovered through use of the building or assignment of the lease through sale to another party, it will affect taxable profit because taxable income will arise either on sale of the right to use the building or by using the building to generate operating profits, and there will be no further tax deduction on recovery of the asset. Consequently, deferred tax arises and must be accounted for.

Ex 25 **An entity has gross trade receivables of CU50,000 with an allowance for bad or doubtful debts set against it for CU2,000. The allowance for bad or doubtful debts is only tax-deductible when the debt is six months overdue and has been written off or sold.**

The expected manner of recovery of the receivables (ie via receipt of cash equal to the carrying amount of CU48,000) will affect taxable profit because CU2,000 will be tax-deductible on recovery of the asset at its carrying amount. Hence, deferred tax must be accounted for. On recovery of the asset, there is no taxable income, because the related revenue will have already been included in taxable income on delivery of the goods or performance of the services.

Note: if the jurisdiction required the tax deduction relating to the allowance for bad or doubtful debts to be taken at the same time as it is expensed for financial reporting purposes, the recovery of the receivables at the carrying amount of CU48,000 would not affect taxable profit because the deduction would have already been made. Consequently, no deferred tax would arise.

Ex 26 **An entity owns land that meets the definition of an investment property in accordance with Section 16 *Investment Property*. The land was acquired for CU200,000 at the beginning of the financial year. If the entity disposes of the land at the reporting date, it would be entitled to a tax deduction of CU201,000 due to indexation of cost for tax purposes. The fair value of the land can be measured reliably without undue cost or effort on an ongoing basis, so the land is measured at fair value with changes in fair value recognised in profit or loss in accordance with Section 16 *Investment Property*. At the reporting date the fair value of the land is CU210,000.**

Because land is a non-depreciable asset (meaning that it would not be depreciated if it was accounted for under Section 17 *Property, Plant and Equipment* at cost), no part of its carrying amount is expected to be recovered (that is, consumed) through use. Hence, the entity expects to recover the carrying amount of the land through sale.

Recovery of the land at its carrying amount through sale is expected to affect taxable profit because taxable income is equal to the carrying amount of CU210,000. This is not fully offset by the available tax deduction of CU201,000. Consequently, deferred tax must be accounted for.

Note: if after initial recognition the fair value of the land cannot be measured reliably without undue cost or effort, meaning that the land is accounted for at cost under Section 17, recovery of the land at its carrying amount through sale would still affect taxable profit. This is because taxable income equal to the carrying amount of CU200,000 would be deemed to arise. The tax deduction of CU201,000 exceeds taxable income by CU1,000 and so this affects taxable profit.

This is unless the tax authorities only allow indexation of the land to the extent that it is covered by sale proceeds, in which case tax deductions would be CU200,000 under the assumption that recovery of the land is at the carrying amount of CU200,000. In this case there would be no effect on taxable profit. This is because equal taxable income and amounts deductible from taxable income would be deemed to arise, and so there would be a nil net effect on taxable profit.

Ex 27 **An entity owns a small number of shares in a listed company which cost CU800. If the entity disposes of the shares at the reporting date, it will be entitled to a tax deduction equal to the cost of the shares. At the reporting date the fair value of the shares is CU1,000**

Equity investments generally have an indefinite life and, therefore their carrying amount will be recovered through sale, even though an entity may choose to hold the shares for the long term for the purpose of earning dividend income.

The investment in shares will be measured at fair value under Section 11 *Basic Financial Instruments.* Recovery of the shares at their carrying amount of CU1,000 will affect taxable profit because taxable income is equal to the carrying amount of CU1,000. This is not fully offset by the available tax deduction of CU800. Consequently, deferred tax arises must be accounted for.

Ex 28 **An entity (functional currency CU) owns shares in an unlisted company overseas (functional currency FCU) which cost CU10,000. The entity has significant influence in the unlisted company (it satisfies the definition of an associate—see Section 14 *Investments in Associates*). If the entity disposes of the shares at the reporting date, it will be entitled to a tax deduction equal to the cost of the shares. At the reporting date the carrying amount of the unlisted company is CU11,000 (the entity accounts for associates using the equity method in accordance with Section 14 *Investments in Associates).***

Equity investments generally have an indefinite life. Consequently, their carrying amount will be recovered through sale, even though an entity may choose to hold the shares for the long term for the purpose of earning dividend income.

Recovery of the shares at their carrying amount of CU11,000 will affect taxable profit because taxable income is equal to the carrying amount of CU11,000. This is not fully offset by the available tax deduction of CU10,000. Consequently, deferred tax arises and must be accounted for.

Ex 29 **An entity acquired a licence for CU5,000 that has a useful life of 10 years. The intangible asset is expected to be used for the full 10 years. No tax deductions can be claimed either as the licence is amortised, or on its expiry or on its sale.**

The expected manner of recovery of the intangible asset (ie using it to generate operating profits (taxable income)) will affect taxable profit. On recovery of the asset there are no tax deductions available. Consequently, deferred tax arises and must be accounted for.

Examples – liabilities where settlement is expected to affect taxable profit

Ex 30 **An entity recognises a warranty provision for CU1,000 to cover the repair of defective items sold prior to the year end. The amount recognised as a provision is not deductible for tax purposes until it is actually paid or used.**

The expected manner of settlement of the liability (ie via the payment of cash to customers or repair of defective items) will affect taxable profit, because any warranty expense is tax-deductible on payment or use. Consequently, deferred tax arises and must

be accounted for. There is no further taxable income on settlement because the related revenue has already been included in taxable income on sale of the goods.

Ex 31 **An entity has an amount payable to an employee of CU10,000 relating to services already rendered by the employee to the entity. The expense is tax-deductible when paid.**

The expected manner of settlement of the liability (ie via the payment of cash to the employee) will affect taxable profit, because the amount is tax-deductible on payment. Consequently, deferred tax arises and must be accounted for. There is no taxable income on settlement because the related benefits generated through the employee service have already been included in taxable income over the period when the employee rendered the service that earned entitlement to the CU10,000.

Ex 32 **An entity recognises a liability for short-term employee benefits for CU500 to cover the annual leave entitlement that has not been used and can be carried forward by employees at the reporting date. The employee benefits are tax-deductible either when used by the employee or if any unused entitlement is paid by the entity.**

The expected manner of settlement of the liability (ie via the employees taking their holiday or forgoing their holiday in return for cash) will affect taxable profit, because the related expense is tax-deductible on use of the holiday or on payment. Consequently, deferred tax must be accounted for. There is no taxable income on settlement because the related benefits generated through the employee service have already been included in taxable income over the period when the employees rendered the service that entitled them to the annual leave.

Ex 33 **Two years ago when the exchange rate was FCU1:CU2 an entity, functional currency CU, borrowed FCU4,000 from a bank. At the latest reporting date the exchange rate was FCU1:CU1.8. Exchange gains are taxable and exchange losses are tax-deductible when realised.**

The loan was initially recognised at CU8,000. At the latest reporting date it was reported at CU7,200. An exchange gain of CU800 has therefore been recognised over the last two years.

The expected manner of settlement of the liability at its carrying amount of CU7,200 (ie via the payment of FCU4,000) will affect taxable profit, because the gain of CU800 will be taxable. There are no tax-deductible amounts on settlement. Consequently, deferred tax arises and must be accounted for.

Tax basis

29.11 An entity shall determine the tax basis of an asset, liability or other item in accordance with enacted or substantively enacted law. If the entity files a consolidated tax return, the tax basis is determined by the tax law governing the consolidated tax return. If the entity files separate tax returns for different operations, the tax basis is determined by the tax laws governing each tax return.

Notes

Tax basis

The tax basis is the measurement, under applicable enacted or substantively-enacted tax law of an asset, liability, equity instrument or other item that was not recognised in the statement of financial position. The notes below paragraph 29.6 explain in detail the meaning of 'substantively enacted'. It may be helpful to think of the tax basis as the amount that would be recognised in a statement of financial position prepared using the applicable tax rules of the relevant jurisdiction. The requirement that the tax basis should be determined by reference to the entity's current status and elections under the tax law also means that future changes in the tax basis of assets cannot be anticipated.

Tax groups

In some tax jurisdictions, groups of entities (ie comprising a parent and its subsidiaries) are permitted to elect to be treated as a single entity for tax purposes. If the group makes the election, then the group will prepare a single consolidated annual tax return rather than preparing a separate tax return for each group entity.

Consequently, in the consolidated financial statements:

- If the entity files a consolidated tax return, the group must follow the tax laws governing the consolidated tax return (eg when determining whether the recovery of an asset or settlement of a liability is expected to affect taxable profit, in determining the tax basis of an asset or liability, etc).
- If the group files separate tax returns for different group entities, the group must follow the tax laws governing the relevant separate tax return for an item. For example, if an item of property in the consolidated financial statements belongs to a subsidiary in the group, the tax laws governing the subsidiary's separate tax return will be followed in determining whether the recovery of the property is expected to affect taxable profit, in determining the tax basis of the property, etc.

Examples – tax basis

Ex 34 **A parent entity has several subsidiaries. One subsidiary transfers a property with a carrying amount of CU10,000 to the parent entity for CU15,000. The group files a consolidated tax return.**

In accordance with Section 9 *Consolidated and Separate Financial Statements*, the unrealised profit of CU5,000 is eliminated from the consolidated financial statements.

The tax basis of the property is determined by the tax law governing the consolidated tax return and will usually remain unchanged by the transfer.

Ex 35 **The facts are the same as in example 34. However, the entity files separate tax returns for the parent entity and each individual subsidiary.**

In accordance with Section 9 *Consolidated and Separate Financial Statements*, the unrealised profit of CU5,000 is eliminated from the consolidated financial statements.

The tax basis is determined by the tax laws governing each tax return. In this case the tax basis of the property will be determined by the parent's tax jurisdiction post transfer

(ie the jurisdiction into which the property is transferred), and may, for example, be equal to the transfer price of CU15,000. This may be a change in the tax basis, because previously the tax basis will have been determined for the subsidiary's tax return by the tax laws in the subsidiary's tax jurisdiction.

29.12 The tax basis determines the amounts that will be included in taxable profit on recovery or settlement of the carrying amount of an asset or liability. Specifically:

(a) the tax basis of an asset equals the amount that would have been deductible in arriving at taxable profit if the carrying amount of the asset had been recovered through sale at the end of the reporting period. If the recovery of the asset through sale does not increase taxable profit, the tax basis shall be deemed to be equal to the carrying amount.

(b) the tax basis of a liability equals its carrying amount less any amounts deductible in determining taxable profit (or plus any amounts included in taxable profit) that would have arisen if the liability had been settled for its carrying amount at the end of the reporting period. In the case of deferred revenue, the tax base of the resulting liability is its carrying amount, less any amount of revenue that will not be taxable in future periods.

Notes (step 2)

Management's expectations – assets

Paragraph 29.10 (step 1 of the deferred tax methodology) requires management's expectations to be considered in assessing how the entity expects to recover the carrying amount of an asset; for example whether management expects to recover an asset through use or sale. If the anticipated method of recovery of the asset is expected to affect taxable profit, then an entity is required to consider that asset when accounting for deferred tax (by applying the steps in the deferred tax methodology). Consequently, management's expectations do play a role initially in the recognition of deferred tax assets and liabilities.

In contrast, the tax basis does not depend on management's expectations of how the carrying amount of an asset will be recovered or a liability will be settled. Although the way in which the carrying amount of an asset is recovered can sometimes affect the available tax deductions relating to an asset (see examples 36 and 37), Section 29 always requires the tax basis to be determined on the basis that the carrying amount of the asset will be recovered through sale (ie determined by tax deductions that are available if the asset is sold at the reporting date). In other words, the tax basis is not affected by how the entity expects to recover the asset. For example, if the tax law allows a company to take a tax deduction for the original cost of the asset upon selling the asset, the tax basis is the original cost of the asset, regardless of whether the entity expects to sell or to use the asset.

Section 29 of the *IFRS for SMEs* uses the approach for determining the tax basis of an asset that was proposed for full IFRSs in exposure draft ED/2009/2 *Income Tax* (published in March 2009)—entities determine the tax basis of an asset based on the recovery of the carrying amount through sale of the asset (see paragraph BC21 and BC22 of the exposure draft ED/2009/2 *Income Tax*). Extracts from these paragraphs are set out below:

BC21 The Board is also aware of problems arising in practice in determining the tax basis of an asset when there are different tax consequences of selling the asset and using the asset. To resolve those problems, the Board proposes to require the tax basis of an asset to be determined by tax deductions that are available if the asset is sold at the reporting date…

BC22 Under the proposals in the exposure draft, the tax basis does not depend on management's expectations of how the carrying amount of the asset will be recovered. But the Board concluded that considering whether the recovery or settlement of an asset or liability would affect taxable profit was an appropriate initial step before starting the deferred tax methodology proposed by the exposure draft. Therefore, under the proposals, management expectation does play a role in an initial threshold for the recognition of deferred tax assets and liabilities. If the entity expects to recover an asset or settle a liability without causing any effect on taxable profit, …, then no deferred tax asset or liability arises…

In summary, the main reason is to avoid the problems that arise in practice in determining which tax deductions are likely to be appropriate when there are different tax consequences depending on whether the asset is sold or used. Consequently, under Section 29, each asset only has one tax basis at any point in time. Note: determination of a tax basis assuming recovery through sale will be hypothetical for assets such as prepayments that are not sold outside a business combination. However, in many cases for those kinds of items, the tax basis assuming recovery through sale will be equal to the tax basis assuming recovery through use or through consumption in the business.

Management's expectations – liabilities

For liabilities, both paragraph 29.10 and paragraph 29.12 (determination of the tax basis) require determination based on the settlement of the liability (neither of the paragraphs specifies whether the term 'settlement' includes possible cancellation or expiry).

Recovery or settlement based on carrying amount

Often an entity will expect the amount received on recovery of an asset, or the amount paid on settlement of a liability, to exceed the carrying amount of the asset or liability. However, Section 29 always looks at the future tax consequences of recovering an asset or settling a liability at its carrying amount at the reporting date. This is explained further under the notes to paragraph 29.10. Consequently, the tax basis of an asset or liability at the reporting date is always determined on the basis that the asset will be sold for its carrying amount, or that the liability will be settled for its carrying amount, at that reporting date.

Probability in determining tax basis

When determining the tax basis of an asset or a liability (or another item—see paragraph 29.13), no assessment is performed regarding how probable it is that the respective amounts will ultimately be deducted or taxed. Instead, the probability assessment is part of the analysis required for the recognition of deferred tax assets. For example, assume an asset costing CU50,000 is being depreciated to CU0 over ten years for tax purposes and over five years for accounting purposes. After four years the entity starts to encounter a reduction in market share for its products and expects to make losses for the next few years. After four years the asset has a carrying amount of CU10,000 (assuming no impairment) and a tax basis of CU30,000. The tax basis is CU30,000 even though the expectation of ongoing losses means the entity may not be able to obtain tax benefits from the deductions (ie from the tax basis). Instead, this probability will be considered when deciding whether a valuation allowance should be recognised against the deferred tax asset (see paragraph 29.21).

Examples – different tax deductions available depending on manner of recovery of asset

Ex 36 **An entity purchases a machine just before its year end. At the entity's year end the machine has a cost and carrying amount of CU1,000 and it is expected to be used within the business to generate operating profits (hence giving rise to taxable income). There is no tax depreciation or other deduction available from use of the machine, but in the event that it is sold, the entity can deduct from taxable profits an amount equal to the lower of the original cost and the sale proceeds. The entity has no expectation to sell the machine because it expects to use the machine until the end of its useful life, at which point it will be scrapped.**

The entity expects to use the machine within its business. Because taxable income is expected to arise from the use of the machine and there are no available tax deductions from use, the expected manner of recovery of the asset (ie use) is expected to affect taxable profit, and hence the machine is identified under step 1 (paragraph 29.10).

The tax basis of an asset equals the amount that is deductible in arriving at taxable profit if the carrying amount of the asset is recovered through sale at the end of the reporting period. Hence, the tax basis is CU1,000, because it is assumed that the asset is sold for its carrying amount of CU1,000 at the reporting date. Even though the entity expects to use the machine within the business, Section 29 always requires the tax basis to be determined based on sale.

Note: in this example, the amount deductible based on use is zero. Hence, if the tax basis could be determined based on use, it would be zero.

Ex 37 **The facts are the same as in example 36. However, in this example, there are no tax deductions available on sale of the machine.**

Even though the entity expects to use the machine within the business, Section 29 always requires the tax basis to be determined based on sale.

The tax basis of the machine is nil because there are no amounts that would have been deductible in arriving at taxable profit if the carrying amount of the machine had been sold for its carrying amount at the end of the reporting period.

Ex 38 **The facts are the same as in example 36. However, in this example, the entity expects to sell the machine immediately after the reporting date, rather than using the machine within the business. The entity expects to receive sale proceeds of CU1,200 for the machine.**

Section 29 assumes that taxable income equal to the carrying amount would arise on sale of the machine (the expected sale proceeds of CU1,200 are not considered). On sale, there is an available tax deduction equal to the carrying amount. Hence, the expected manner of recovery of the asset (ie sale) is not expected to affect taxable profit because equal taxable income and amounts deductible from taxable income would arise (both equal to the carrying amount of the machinery). Hence, the machine does not need to be identified under step 1 of the deferred tax methodology (see paragraph 29.10). Consequently, no deferred tax arises, so no deferred tax accounting needs to be applied for the machine (ie step 2 of the methodology does not need to be applied, and so the tax basis does not need to be identified).

Examples – assets where recovery is expected to affect taxable profit

In examples 22 to 29 under paragraph 29.10, the following assets were identified as being expected to affect taxable profit on their recovery and so step 2 of the deferred tax methodology must be applied.

Ex 39 **The facts are the same as in example 22—an entity has an asset of CU1,000 for interest receivable on a variable-rate bank deposit. The interest will be taxed when the cash is received.**

If the interest receivable were sold for its carrying amount, tax would be payable on the proceeds with no tax deductions.

The tax basis of the interest receivable is nil—nothing is deductible in arriving at taxable profit if the carrying amount of the interest receivable is recovered through sale at the end of the reporting period.

Ex 40 **The facts are the same as in example 23—an entity has a machine that is measured at depreciated cost. The cost of the machine is deductible from taxable income either as the machine is used (via tax depreciation) or, alternatively, on sale. Tax depreciation is applied on a faster basis than depreciation for financial reporting purposes. Revenue generated by using the machine is taxable. If the asset is sold, deductions of 100 per cent of cost are available but all previous deductions received for use must be returned (ie a clawback of all previous deductions)..**

The tax basis equals the amount that is deductible in arriving at taxable profit if the carrying amount of the machine is recovered through sale at the end of the reporting period (ie the tax basis is equal to the cost of the machine less the tax depreciation applied up to the reporting date).

Because tax depreciation is applied on a faster basis than depreciation for financial reporting purposes, the tax basis is always less than the carrying amount of the machine. For example, assume that an item of machinery has a cost of CU100 and that so far CU30 of depreciation has been applied for financial reporting purposes. Assume that for tax purposes, depreciation of CU40 has been deducted in the current and prior periods and the remaining cost will be deductible in future periods either as depreciation or through a deduction on disposal. The machine has a carrying amount of CU70 (ie CU100 less CU30) and a tax basis of CU60 (ie CU100 less CU40).

If tax depreciation were applied on a slower basis than depreciation for financial reporting purposes, the tax basis of the machine would be larger than the carrying amount of the machine.

Ex 41 **The facts are the same as in example 24—an entity leases its office building under an operating lease. It has an asset for CU6,000 equal to a prepayment of six months of rent. Rents are tax-deductible when they are paid to the landlord.**

The tax basis of the prepaid rent is nil—there would be no further tax deduction on sale of the prepayment at the reporting date.

Ex 42 **The facts are the same as in example 25—an entity has gross trade receivables of CU50,000 with an allowance for bad or doubtful debts set against it for CU2,000. The allowance for bad or doubtful debts is only tax-deductible when the debt is six months overdue and has been formally written off or is sold.**

The tax basis is CU50,000—the amount that would be deductible in arriving at taxable profit if the receivables were sold for their carrying amount at the end of the reporting period.

Ex 43 **The facts are the same as in example 26—an entity owns land that meet the definition of an investment property in accordance with Section 16 *Investment Property*. The land was acquired for CU200,000 at the beginning of the financial year. If the entity disposes of the land at the reporting date, it would be entitled to a tax deduction of CU201,000 because of indexation of cost for tax purposes. The fair value of the land can be measured reliably without undue cost or effort on an ongoing basis, so the land is measured at fair value with changes in fair value recognised in profit or loss in accordance with Section 16. At the reporting date the fair value of the land is CU210,000.**

The tax basis is CU201,000—the amount that is deductible in arriving at taxable profit if the carrying amount of the land is recovered through sale at the end of the reporting period.

Ex 44 **The facts are the same as in example 27—an entity owns a small number of shares in a listed company which cost CU800. If the entity disposes of the shares at the reporting date, it would be entitled to a tax deduction equal to the cost of the shares. At the reporting date the fair value of the shares is CU1,000.**

The tax basis is CU800—the amount that is deductible in arriving at taxable profit if the carrying amount of the shares is recovered through sale at the end of the reporting period

Ex 45 **The facts are the same as in example 28—an entity (functional currency CU) owns shares in an unlisted company overseas (functional currency FCU) which cost CU10,000. The entity has significant influence in the unlisted company and so it is an associate of the entity. If the entity disposes of the shares at the reporting date, it will be entitled to a tax deduction equal to the cost of the shares. At the reporting date the carrying amount of the listed company is CU11,000. The entity accounts for investments in associates using the equity method in accordance with Section 14 *Investments in Associates.***

The tax basis is CU10,000—the amount that is deductible in arriving at taxable profit if the carrying amount of the shares is recovered through sale at the end of the reporting period.

Note: the tax basis of the investment is unaffected by the changes in foreign exchange rates and the amounts included in consolidated retained earnings.

Ex 46 **The facts are the same as in example 29—an entity acquired a licence for CU5,000 that has a useful life of 10 years. The intangible asset is expected to be used for the full 10 years. No tax deductions can be claimed either as the licence is amortised, on its expiry or on its sale.**

The tax basis is nil—there would be no tax deduction on sale of the licence.

Examples – liabilities where settlement is expected to affect taxable profit

In examples 30 to 33 the following liabilities were identified as being expected to affect taxable profit on their settlement and so step 2 of the deferred tax methodology must be applied.

Ex 47 **The facts are the same as in example 30—an entity recognises a warranty provision for CU1,000 to cover the repair of defective items sold prior to the year end. The amount recognised as a provision is not deductible for tax purposes until actually paid or used.**

The tax basis of the warranty provision is nil—the tax basis of the warranty provision equals its carrying amount (CU1,000) less any amounts that would be deductible in determining taxable profit (CU1,000) (or plus any amounts that would be included in taxable profit (nil)) if the provision were settled for its carrying amount at the end of the reporting period. The amount deductible in determining taxable profit is equal to the carrying amount of the warranty provision because the expense is tax-deductible when settled.

Ex 48 **The facts are the same as in example 31—an entity has an amount payable to an employee of CU10,000 relating to services already rendered by the employee to the entity. The expense is tax-deductible when paid.**

The tax basis of the obligation is nil—the tax basis equals its carrying amount (CU10,000) less any amounts deductible in determining taxable profit (CU10,000) that would arise if the obligation were settled for its carrying amount at the end of the reporting period. The amount deductible in determining taxable profit is equal to the carrying amount of the amount payable because the expense is tax-deductible when it is settled.

Ex 49 **The facts are the same as in example 32—an entity recognises a liability for short-term employee benefits for CU500 to cover the yearly leave entitlement that has not been used and that can be carried forward by employees at the reporting date. The employee benefits are deductible in determining taxable profit when either used by the employee or, if any unused entitlement is paid by the entity.**

The tax basis of the liability is nil—the tax basis equals its carrying amount (CU500) less any amounts deductible in determining taxable profit (CU500) that would arise if the obligation were settled for its carrying amount at the end of the reporting period. The payment to employees in settlement of the leave pay obligation is deductible in determining taxable profit when paid.

Ex 50 **The facts are the same as in example 33—two years ago when the exchange rate was FCU1:CU2 an entity, functional currency CU, borrowed FCU4,000 from a bank. At the latest reporting date the exchange rate was FCU1:CU1.8. Exchange gains are taxable and exchange losses are tax-deductible when realised.**

The loan was initially recognised at CU8,000. At the latest reporting date it was reported at CU7,200. The exchange gain to date is CU800.

If the liability was settled at its carrying amount of CU7,200 on the reporting date (ie via the payment of FCU4,000) the gain of CU800 would be realised and hence it would be taxable.

The tax basis of a liability equals its carrying amount less any amounts deductible in determining taxable profit (or plus any amounts included in taxable profit) that would have arisen if the liability had been settled for its carrying amount at the end of the expected reporting period. The CU800 would be included in taxable profit. Consequently, the tax basis is CU8,000 (ie CU7,200 + CU800).

Ex 51 **A machine manufacturer leases a machine to a customer for three years under an operating lease. The customer (lessee) pays CU3,000 which covers three months of rent in advance. The deferred rental income is taxed when received in cash.**

The tax basis of the deferred revenue is nil—the tax basis of deferred revenue is its carrying amount (CU3,000), less any amount of revenue that will not be taxable in future periods (CU3,000). The rent received in advance will not be taxable in future periods because it is taxable in the period in which the cash was received (ie the amount of revenue that will not be taxed is equal to the carrying amount of the deferred revenue, and so the tax basis is nil).

Ex 52 **A magazine manufacturer and distributor provides customers with one-year subscriptions to different magazines. The customers pay the one-year subscription fee of CU800 in advance. The subscription income is taxed when received in cash.**

The tax basis of the deferred revenue is nil—the tax basis of deferred revenue is its carrying amount (CU800), less any amount of revenue that will not be taxable in future periods (CU800). The income received in advance will not be taxable in future periods because it is taxable in the period in which the cash was received (ie the amount of revenue that will not be taxed is equal to the carrying amount of the deferred revenue, and so the tax basis is nil).

Examples – additional examples: tax basis when income or expense is recognised in different accounting periods for tax purposes and financial reporting purposes

In examples 53 to 60 the assets and liabilities have already been identified in step 1 (see paragraph 29.3(b)) as being expected to affect taxable profit on the recovery or settlement of their carrying amount. If this were not the case there would be no need to determine the tax basis, because no deferred tax arises.

Assets

Ex 53 **An entity purchases equipment and receives a tax deduction in the current period equal to the cost of the equipment.**

The tax basis of the equipment is nil because there are no further tax deductions for the equipment.

Ex 54 **An entity purchases legal rights to operate in a particular area for 20 years. The acquired intangible asset is recognised at cost under Section 18 *Intangible Assets other than Goodwill* and is amortised over its 20-year useful life.**

The asset is not depreciable for tax purposes. However, if the right is used for the full 20 years, then at the expiry date a tax deduction will be received for an amount equal to the initial cost. If the intangible is sold or abandoned in the future, no deduction is available.

The tax basis is nil regardless of whether the entity expects to use the right for the full 20 years. The tax basis always equals the amount that is deductible if the carrying amount of the asset is recovered through sale at the end of the reporting period.

Ex 55 **An entity purchases a machine for use in its business. Deductions of 15 per cent of the cost of an asset are available in each of up to ten years if the asset is used only to produce environmentally friendly products. Deductions of 10 per cent of cost are available in each of up to ten years if the machine is used in any other way. A deduction equal to the initial cost of the machine is available on sale with deductions of 10 per cent previously claimed repayable.**

The tax basis of the machine is cost less any 10 per cent deductions already received. So, for example, if the machine cost CU100, the tax basis after three years would be CU70 regardless of whether the machine was used to produce environmentally friendly products or not (ie regardless of whether deductions of 15 per cent of cost or 10 per cent of cost have been claimed in the previous three years).

Ex 56 **At the reporting date the entity assesses that the selling price less costs to complete and sell of an item of inventory (or the recoverable amount of an item of property, plant or equipment) is less than the previous carrying amount, and the entity therefore reduces the carrying amount of the asset. That reduction is ignored for tax purposes until the asset is sold (eg the entire cost of inventory is deductible only on sale).**

The tax basis of the asset does not include the impairment.

Ex 57 **An entity remeasures certain financial assets and investment properties at fair value but no equivalent adjustments are made for tax purposes.**

The tax basis of the assets will not change over time. Hence, the tax basis will be equal to the initial tax basis (before fair value adjustments are made). The initial tax basis is usually cost.

Note: in some jurisdictions, the remeasurement of an asset or liability to fair value affects taxable profit for the current period. As a result, the tax basis of the asset or

liability is adjusted and is usually equal to carrying amount. In other jurisdictions, the remeasurement of an asset or liability does not affect taxable profit in the period of the remeasurement and, consequently, the tax basis of the asset or liability is not adjusted.

Ex 58 **An entity receives interest income on an investment in a bond. Interest is received in arrears. It is included in accounting profit or loss on an effective interest rate basis but is included in taxable profit on a cash basis. If the accrued interest were sold for its carrying amount, tax would be payable on the proceeds with no tax deductions.**

The tax basis of the interest receivable is nil.

Liabilities

Ex 59 **An entity pays rent in arrears and therefore the entity recognises a liability for accrued rental expenses. The related expense will be deducted for tax purposes on a cash basis.**

If the accrued expenses were settled for its carrying amount, tax deductions equal to the carrying amount would be available. The tax basis of the accrual is therefore nil.

Ex 60 **Pension costs are deducted in determining accounting profit or loss as service is provided by the employees. However, pension costs are not deducted in determining taxable profit until the entity either pays retirement benefits or pays contributions to a fund. The entity has a liability for outstanding payments due.**

If the pension liability were settled for its carrying amount, tax deductions equal to the carrying amount would be available. The tax basis of the pension liability is therefore nil.

Example – changes in the tax basis of an asset or liability that will not be recognised in its carrying amount

In example 61 the asset has already been identified in step 1 (see paragraph 29.3(b)) as being expected to affect taxable profit on the recovery or settlement of its carrying amount. If this had not been the case there would be no need to determine the tax basis because no deferred tax arises.

Ex 61 **An entity purchases an asset and receives no tax deductions in the current period. However, deductions equal to an indexed cost are available when the asset is sold. Such deductions are available even if the proceeds are lower than the indexed cost, giving rise to a tax loss.**

The tax basis of the asset is equal to indexed cost at each reporting date.

Note: in some tax jurisdiction the deductions available (and hence the tax basis) will be equal to the lower of the indexed cost and the proceeds. In other jurisdictions, the deductions available (and hence the tax basis) will be equal to the lower of the indexed cost and the sale proceeds, but will never be less than the original cost. Consequently, it is important to identify the appropriate rules in the jurisdiction in question when determining the tax basis.

Examples – initial recognition of assets and liabilities in a business combination

In examples 62 and 63 the assets and liabilities have already been identified in step 1 (see paragraph 29.3(b)) as being expected to affect taxable profit on the recovery or settlement of their carrying amount. If this were not the case there would be no need to determine the tax basis because no deferred tax arises.

Ex 62 **An asset is recognised at fair value in a business combination and no equivalent adjustment is made for tax purposes.**

The tax basis of the asset is the same as it was before the business combination.

Ex 63 **A liability is recognised at its fair value in a business combination but the related expense is not deducted in determining taxable profits until a later period.**

If the liability is settled for its fair value, deductions equal to fair value will be available, so the tax basis is nil.

29.13 Some items have a tax basis but are not recognised as assets and liabilities. For example, research costs are recognised as an expense when they are incurred but may not be permitted as a deduction in determining taxable profit until a future period. Thus, the carrying amount of the research costs is nil and the tax basis is the amount that will be deducted in future periods. An equity instrument issued by the entity may also give rise to deductions in a future period. There is no asset or liability in the statement of financial position, but the tax basis is the amount of the future deductions.

Examples – tax basis of unrecognised assets and liabilities

Ex 64 **Research costs of CU3,000 are recognised as an expense in determining accounting profit but are not permitted as a deduction in determining taxable profit until a later period.**

The tax basis of the research costs is CU3,000—the amount that will be available as a deduction against taxable profit in the future.

Ex 65 **An entity grants 10 share options to each of its 20 employees. Each grant is conditional upon the employee working for the entity over the next 3 years. The entity estimates that the fair value of each share option is CU9 on the grant date. Tax deductions will be received on the exercise of the share options with the measurement of the tax deduction being equal to intrinsic value (ie the entity's share price at the date of exercise minus the exercise price).**

Assume that the exercise price is CU10 and that the share price is estimated using a valuation model at each year end as follows:

End of year one: CU13

End of year two: CU16

End of year three: CU19

End of year four: CU18

The share options are an example of equity instruments issued by the entity that do not give rise to assets or liabilities but do give rise to deductions in a future period. The total staff cost recognised in each of the three years, assuming that all options vest, is CU600 (ie 20 employees × 10 shares × CU9 × 1 year ÷ 3 years) (see Section 26 *Share-based Payment*). At no point is an asset or liability recognised, because the cumulative expense is credited to equity (debit to profit or loss) for equity-settled share based payments.

The tax basis will be as follows assuming that all options vest:

- After the first year the share-based payment has a tax basis of CU200 (ie (CU13 share price less CU10 exercise price) × 20 employees × 10 shares × 1 year ÷ 3 years). The tax basis of the employee services received is based on the intrinsic value of the options, and those options were granted for three years' services. Because only one year's services have been received to date, it is necessary to multiply the option's intrinsic value by one-third to arrive at the tax basis of the employee services received in year 1.
- After the second year the tax basis is CU800 (ie (CU16 share price less CU10 exercise price) × 20 employees × 10 shares × 2 years ÷ 3 years).
- After the third year the tax basis is CU1,800 (ie (CU19 share price less CU10 exercise price) × 20 employees × 10 shares).
- After the fourth year the tax basis is CU1,600 (ie (CU18 share price less CU10 exercise price) × 20 employees × 10 shares).

The tax basis will change as the valuation of the share price changes until the options are exercised.

Temporary differences

29.14 Temporary differences arise:

(a) when there is a difference between the carrying amounts and tax bases on the initial recognition of assets and liabilities, or at the time a tax basis is created for those items that have a tax basis but are not recognised as assets and liabilities.

(b) when a difference between the carrying amount and tax basis arises after initial recognition because income or expense is recognised in comprehensive income or equity in one reporting period but is recognised in taxable profit in a different period.

(c) when the tax basis of an asset or liability changes and the change will not be recognised in the asset or liability's carrying amount in any period.

Notes (step 3)

Temporary differences are defined as differences between the carrying amount of an asset, liability or other item in the financial statements, and its tax basis that the entity expects will affect taxable profit when the carrying amount of the asset or liability is recovered or settled (or, in the case of items other than assets and liabilities, will affect taxable profit in the future).

Timing differences (paragraph 29.14(b))

Paragraph 29.14(b) notes that temporary differences arise when a difference between the carrying amount and tax basis arises after initial recognition because income or expense is recognised in comprehensive income or equity in one reporting period, but is recognised in taxable profit in a different period. Such temporary differences are sometimes described as timing differences. For example, timing differences arise in the following cases:

(a) An expenditure is deductible for tax purposes later than when it is recognised as an expense for financial reporting purposes. For example:

  (i) pension or other employee benefit cost is recognised as an expense in accounting profit over the periods of employee service, but, in some jurisdictions, is deductible for tax purposes only in future periods when contributions or payments are made (see example 60).

  (ii) warranty expense is recognised in accounting profit when the related sales are made, but, in some jurisdictions, is deductible for tax purposes only when paid (see example 47).

  (iii) bad debts expense is recognised in accounting profit when the accounts receivable are estimated to be uncollectible, but, in some jurisdictions, is tax-deductible only when a customer enters formal bankruptcy proceedings (see example 42).

(b) Income is taxable earlier than when it is recognised for financial reporting purposes. For example:

  (i) advance payments received from customers, but that do not yet qualify for recognition as revenue in accordance with the *IFRS for SMEs*, are, in some jurisdictions, taxed on a cash basis.

  (ii) intragroup profits in inventories, unrealised at the group level, are reversed on consolidation but, in some jurisdictions, are taxed on transfer date.

(c) Income is taxable later than when it is recognised for financial reporting purposes. For example:

  (i) an increase in the fair value of an asset is recognised in accounting profit, but, in some jurisdictions, that increase is taxable only when the asset is sold (see example 57).

  (ii) revenue is recognised in accounting profit by reference to the stage of completion of a contract or transaction (sometimes referred to as the percentage of completion method), but, in some jurisdictions, for tax purposes revenue is taxable only when the contract or transaction is completed.

  (iii) the unremitted earnings of subsidiaries, associates and joint ventures are recognised in accounting profit but, in some jurisdictions, will be subject to further taxation only when remitted to the parent.

(d) An expense is deductible for tax purposes earlier than when it is recognised as an expense for financial reporting purposes. For example, in some jurisdictions an asset is depreciated more rapidly for tax purposes than for financial reporting purposes (see example 40).

Other temporary differences that are not timing differences (paragraph 29.14(a) and (c))

Examples of temporary difference described by paragraph 29.14(a) include:

- Those arising in a business combination when the carrying amounts of assets and liabilities are adjusted to their fair values at the date of acquisition. In some

jurisdictions, the tax bases of those assets and liabilities are not affected by the business combination or are affected differently (see examples 62 and 63)

- Those arising on the initial recognition of an asset or liability; for example, if part or all of the cost of an asset will not be deductible for tax purposes. This may occur when an entity benefits from a non-taxable government grant related to assets. Another example is provided in example 46.

Examples of temporary difference described by paragraph 29.14(c) include where the taxation authority permits indexation of, or other adjustments to, the cost of an asset for tax purposes, but the asset is not remeasured for financial reporting purposes (see example 66) or taxable profit is determined in a different currency to the functional currency.

Examples – assets where recovery is expected to affect taxable profit

Ex 66 **The following table lists the carrying amounts and tax bases of the assets that were expected to affect taxable profit on recovery in examples 22 to 29. The tax bases of those same assets were determined in examples 39 to 46. Consequently:**

(i) these assets have already been identified under step 1 of the deferred tax methodology (see paragraph 29.10) as being expected to affect taxable profit via the expected manner of recovery of the asset for its carrying amount at the reporting date.

(ii) the tax bases of the assets at the reporting date have been determined under step 2 (see paragraph 29.12).

Consequently, for all those assets where the carrying amount of the asset is different from its tax basis, a temporary difference arises. This is actually true for all of the assets in question—see the table below (this is step 3 (see paragraph 29.3(d)) of the deferred tax methodology).

	Carrying amount CU	*Tax basis* CU	*Temporary difference* CU
Example 39 (interest receivable)	1,000	–	1,000
Example 40 (machine)	70	60	10
Example 41 (rent prepayment)	6,000	–	6,000
Example 42 (trade receivables with bad debt provision)	48,000	50,000	2,000
Example 43 (investment property - land)	210,000	201,000	9,000
Example 44 (shares in listed company)	1,000	800	200
Example 45 (investment in associate)	11,000	10,000	1,000
Example 46 (licence)	5,000	–	5,000

Examples – liabilities where settlement is expected to affect taxable profit

Ex 67 **The following table lists the carrying amounts and tax bases of the liabilities that were expected to affect taxable profit on settlement in examples 30 to 33. The tax bases of those same liabilities were determined in examples 47 to 52. Consequently:**

(i) these liabilities have already been identified under step 1 of the deferred tax methodology (paragraph 29.10) as being expected to affect taxable profit via

the expected manner of settlement of the liability for its carrying amount at the reporting date.

(ii) the tax bases of the liabilities at the reporting date have been determined under step 2 (paragraph 29.12).

Consequently, for all those liabilities where the carrying amount of the liability is different from its tax basis, a temporary difference arises. This is actually true for all of the liabilities in question.

	Carrying amount CU	*Tax basis* CU	*Temporary difference* CU
Example 47 (warranty provision)	1,000	–	1,000
Example 48 (salary payable)	10,000	–	10,000
Example 49 (annual leave accrual)	500	–	500
Example 50 (foreign currency loan)	7,200	8,000	800
Example 51 (deferred revenue less rental income)	3,000	–	3,000
Example 52 (deferred revenue less subscription income)	800	–	800

Examples – items that have a tax basis but that are not recognised as assets and liabilities

Ex 68 **As in example 64, research costs of CU3,000 are recognised as an expense in determining accounting profit or loss but are not permitted as a deduction in determining taxable profit until a later period.**

The deduction available will affect taxable profit in the future and hence a temporary difference of CU3,000 arises. This is the difference between the carrying amount of nil and the tax basis of CU3,000.

Ex 69 **As in example 65, an entity grants 10 share options to each of its 20 employees. Each grant is conditional upon the employee working for the entity over the next 3 years. The entity estimates that the fair value of each share option is CU9. Tax deductions will be received on exercise of the share options based upon the intrinsic value on the exercise date.**

The tax deductions available will affect taxable profit in the future and hence after the first year a temporary difference of CU600 arises. This is the difference between the carrying amount of nil and the tax basis of CU200. Similarly the temporary difference after years two, three and four are CU800, CU1,800 and CU1,600 respectively.

Deferred tax liabilities and assets

29.15 Except as required by paragraph 29.16, an entity shall recognise:

(a) a deferred tax liability for all temporary differences that are expected to increase taxable profit in the future.

(b) a deferred tax asset for all temporary differences that are expected to reduce taxable profit in the future.

(c) a deferred tax asset for the carryforward of unused tax losses and unused tax credits.

Notes – deferred tax assets and liabilities (step 4)

Temporary differences expected to increase taxable profit (paragraph 29.15(a))

For assets that are expected to affect taxable profit on recovery, a temporary difference that is expected to increase taxable profit in the future arises when the carrying amount of the asset exceeds its tax basis (eg interest receivable which is taxed when cash is received). As the carrying amount of the asset is recovered, the economic benefits that are subject to tax (the carrying amount of interest receivable) will exceed the future tax deductions available (ie the tax basis—in the case of the interest receivable this is nil). Consequently, this tax effect gives rise to a deferred tax liability in respect of additional taxes, which will be payable in future periods.

For liabilities that are expected to affect taxable profit on settlement, a temporary difference that is expected to increase taxable profit in the future arises when the tax basis of the liability exceeds its carrying amount (eg a foreign currency loan payable that has been reduced for financial reporting purposes by an exchange gain that will be taxable when the loan is repaid and the gain is realised). If the loan is settled at its carrying amount, a taxable gain will arise. Consequently, this tax effect gives rise to a deferred tax liability in respect of additional taxes that will be payable in future periods.

For other items that have a tax basis but that are not recognised as assets and liabilities, the amount of the tax basis will either be future taxable income or it will be a future tax deduction. If the value of the tax basis will be future taxable income, a temporary difference that is expected to increase taxable profit in the future arises. Consequently, this tax effect gives rise to a deferred tax liability in respect of additional taxes, which will be payable in future periods.

Temporary differences expected to reduce taxable profit (paragraph 29.15(b))

For assets that are expected to affect taxable profit on recovery, a temporary difference that is expected to reduce taxable profit in the future arises when the tax basis of the asset exceeds its carrying amount (eg when the carrying amount of trade receivables has been reduced by a bad debt allowance, but the allowance is not deductible for tax purposes until the debt is formally written off). If the asset is settled at its carrying amount, a net deduction will arise. Consequently, this tax effect gives rise to a deferred tax asset in respect of a reduction in taxes payable in future periods.

For liabilities, a temporary difference that is expected to reduce taxable profit in the future arises when the carrying amount of the liability exceeds its tax basis (eg where a warranty expense and provision has been recognised but no tax deduction is available until the amount is paid or used). If the provision is settled at its carrying amount, a net deduction will arise. Consequently, this tax effect gives rise to a deferred tax asset in respect of a reduction in taxes payable in future periods.

For other items that have a tax basis but are not recognised as assets and liabilities, the amount of the tax basis will either be future taxable income or a future tax deduction. If the value of the tax basis will be a future tax deduction, a temporary difference that is expected to reduce taxable profit in the future arises. Consequently, this tax effect gives rise to a deferred tax asset in respect of a reduction in taxes payable in future periods.

Summary of paragraph 29.15(a) and (b)

Item in statement of financial position	*Tax basis*	*Recognise the following*
Asset	Carrying amount > Tax basis	Deferred tax liability (paragraph 29.15(a))
Asset	Carrying amount < Tax basis	Deferred tax asset (paragraph 29.15(b))
Liability	Carrying amount > Tax basis	Deferred tax asset (paragraph 29.15(b))
Liability	Carrying amount < Tax basis	Deferred tax liability (paragraph 29.15(a))
No asset or liability	Tax basis ≠ zero; the amount of tax basis is available as a tax deduction in the future	Deferred tax asset (paragraph 29.15(b))
No asset or liability	Tax basis ≠ zero; the amount of tax basis will be taxable income in the future	Deferred tax liability (paragraph 29.15(a))

Carry forward of unused tax losses and unused tax credits (paragraph 29.15(c))

A tax credit is a tax benefit that takes the form of an amount that reduces income taxes payable (ie the tax credit reduces the actual amount of tax that must be paid directly). Tax credits differ from tax deductions because a tax deduction reduces taxable profits (note: tax payable for the year = taxable profits × tax rate). Consequently, tax credits give rise to a deferred tax asset in respect of a direct reduction in taxes payable in future periods.

A tax loss will arise in an accounting period where taxable income is negative (ie allowable deductions exceed the income that is taxable). Some tax laws allow entities to use a tax loss in one year to offset taxable profits in one or more prior years, in which case a current tax asset may be recognised in the period in which the tax loss occurs (see paragraph 29.5).

If the entity is unable to carry back the tax loss (eg it is not permitted by rules in the jurisdiction or the entity does not have enough taxable profits in prior years to offset the entire loss) the entity may be able to carry the tax loss forward with or without a time limit and set the tax loss against taxable income in a future period. Where tax losses can be carried forward against taxable profits of future periods, a reduction in future tax payments is available. Consequently, this tax effect gives rise to a deferred tax asset in respect of a reduction in taxes payable in future periods.

If the entity is unable to either carry forward or carry back the loss, the tax loss is not usable and so it is lost.

Recognition of deferred tax assets

Deferred tax assets are recognised in full even if there is doubt over whether they can be realised. However, where there is doubt over whether a deferred asset can be realised, Section 29 requires a valuation allowance to be recognised against the deferred tax asset. For example, if an entity is making losses, there may be doubt over whether it can use any carried-forward unused tax losses in the future to offset future taxable profits, because the entity may continue to make losses (ie it will have insufficient future taxable profits). Paragraphs 29.21 and 29.22 discuss the recognition of the valuation allowance. Consequently, examples 70 to 80 only look at whether a deferred tax asset exists (step 4). Deferred tax assets and liabilities are measured in step 5 (gross measurement) and step 6 (valuation allowance).

Examples – assets where recovery is expected to affect taxable profit

Ex 70 **The following table lists whether or not the items listed in example 66 result in deferred tax assets or liabilities. Note: measurement of such items, including determination of the appropriate tax rate, is discussed under paragraphs 29.18–29.20. Assume for simplicity that the appropriate tax rate to use for the deferred tax asset or liability is always 20 per cent.**

	Carrying amount CU	*Tax basis CU*	*Temporary difference CU*	*Deferred tax asset or liability?*
Example 39 (interest receivable)	1,000	–	1,000	DT liability of CU200
Example 40 (machine)	70	60	10	DT liability of CU2
Example 41 (rent prepayment)	6,000	–	6,000	DT liability of CU1,200
Example 42 (trade receivables with bad debt provision)	48,000	50,000	2,000	DT asset of CU400
Example 43 (investment property - land)	210,000	201,000	9,000	DT liability of CU1,800
Example 44 (shares in listed company)	1,000	800	200	DT liability of CU40
Example 45 (investment in associate)	11,000	10,000	1,000	DT liability of CU200
Example 46 (licence)	5,000	–	5,000	DT liability of CU1,000

Example – liabilities where settlement is expected to affect taxable profit

Ex 71 **The following table lists whether or not the items listed in example 67 result in deferred tax assets or liabilities. Note: measurement of such items, including determination of the appropriate tax rate, is discussed under paragraphs 29.18–29.20. Assume for simplicity that the appropriate tax rate to use for the deferred tax asset or liability is always 20 per cent.**

	Carrying amount CU	*Tax basis CU*	*Temporary difference CU*	*Deferred tax asset or liability*
Example 47 (warranty provision)	1,000	–	1,000	DT asset of CU200
Example 48 (salary payable)	10,000	–	10,000	DT asset of CU2,000
Example 49 (annual leave accrual)	500	–	500	DT asset of CU100
Example 50 (foreign currency loan)	7,200	8,000	800	DT liability of CU160
Example 51 (deferred revenue less rental income)	3,000	–	3,000	DT asset of CU600
Example 52 (deferred revenue less subscription income)	800	–	800	DT asset of CU160

Examples – items that have a tax basis but are not recognised as assets and liabilities

Ex 72 **The facts are the same as in example 68—research costs of CU3,000 are recognised as an expense in determining accounting profit or loss, but are not permitted as a deduction in determining taxable profit until a later period.**

A temporary difference of CU3,000 arises. This is the difference between the carrying amount of nil and the tax basis of CU3,000.

The amount of the tax basis will be a future tax deduction. Consequently, this is a temporary difference that is expected to reduce taxable profit in future periods (ie, it is a deferred tax asset).

A deferred tax asset will arise for an amount equal to CU3,000 × appropriate tax rate (see paragraphs 29.18–29.20 for a discussion on measurement).

Note: this may be thought of in another way. Research costs are an asset for tax purposes (ie capitalised and amortised at a later date). For financial reporting purposes the entity has an asset with a carrying amount of zero. For an asset, if the carrying amount is less than the tax basis (CU3,000) a deferred tax asset arises (see the table above).

Ex 73 **The facts are the same as in example 65—an entity grants 10 share options to each of its 20 employees. Each grant is conditional upon the employee working for the entity over the next 3 years. The entity estimates that the fair value of each share option is CU9. Tax deductions will be received on exercise of the share options based upon intrinsic value on the exercise date.**

The tax deductions available will affect taxable profit in the future and hence, after the first year, a temporary difference of CU200 arises as the difference between the carrying amount of nil and the tax basis of CU200. Similarly, the temporary difference after years two, three and four are CU800, CU1,800 and CU1,600 respectively.

Here the amount of the tax basis will be a future tax deduction. This is a temporary difference that is expected to reduce taxable profit in future periods, ie it is a deferred tax asset.

Hence, in the first year a deferred tax asset will arise for an amount equal to CU200 × appropriate tax rate (see paragraph 29.18–29.20 for a discussion on measurement). In the second year this will be CU800 × appropriate tax rate. In the third year this will be CU1,800 × appropriate tax rate. In the fourth year this will be CU1,600 × appropriate tax rate.

Example – carryforward of unused tax credits and tax losses

Ex 74 **An entity calculates its taxable income to be negative CU9,000 (ie a tax loss of CU9,000) for the tax period 20X7/20X8 in accordance with the relevant tax rules in its jurisdiction. The tax legislation in the jurisdiction does not permit entities to carry back tax losses. The tax rate in the jurisdiction is 30 per cent (assume for simplicity that this is the rate that is expected to apply in the period when the tax loss of CU9,000 is expected to be used—measurement is discussed under paragraphs 29.18–29.20).**

The tax loss may be used to reduce taxable profit in the future. Hence a deferred tax asset of CU2,700 (ie CU9,000 × 30%) should be recognised in respect of a reduction in taxes payable in future periods.

Ex 75 **In an entity's jurisdiction, in the 20X7/20X8 tax year the government provided all entities with a tax credit of CU3,000 which can be set off against income tax in that year for each additional full-time employee hired in the year. The entity hired two new full time employees and is therefore entitled to tax credits worth CU6,000. If tax credits cannot be used in the current tax year they may be carried forward to future tax years. In 20X7/20X8 taxable profits are CU10,000. The tax rate for 20X7/20X8 in the jurisdiction is 25 per cent.**

The tax credit may appear to meet the definition of a government grant. However, Section 24 *Government Grants* specifically excludes from its scope government assistance that is provided for an entity in the form of benefits that are limited on the basis of the income tax liability (see paragraph 24.3). Consequently, the requirements of Section 24 do not apply in this case.

Current tax payable in 20X7/20X8 is CU2,500 (ie CU10,000 × 25%). Consequently, the entity can only use CU2,500 of its tax credits to offset current tax for the year. The remaining CU3,500 may be carried forward to a future period. Hence, a deferred tax asset of CU3,500 is recognised.

Note: there is no need to apply the tax rate to the tax credit in determining the deferred tax asset because the tax credit is available for offset directly against tax payable, rather than against taxable income.

29.16 The following are exceptions to the requirements of paragraph 29.15:

(a) An entity shall not recognise a deferred tax asset or liability for temporary differences associated with unremitted earnings from foreign subsidiaries, branches, associates and joint ventures to the extent that the investment is essentially permanent in duration, unless it is apparent that the temporary difference will reverse in the foreseeable future.

Notes

The expected manner of recovery of investments in subsidiaries, branches, associates and joint ventures may give rise to tax consequences in addition to those arising from the recovery or settlement of the individual assets or liabilities within those investments. For example, tax may be payable or refundable on the payment of distributions from the investee to the investor. Tax may be payable on the sale of the investment. Investments in subsidiaries, branches, associates and joint ventures have a tax basis in the investor's tax jurisdiction in respect of these taxes.

Temporary differences arise when the carrying amount of an investment in a subsidiary, associate or a joint venture in the consolidated financial statements (eg the parent's share of the net assets of a subsidiary, including the carrying amount of goodwill) differs from the tax basis of the investment (note: this is always determined based on sale and is often cost or indexed cost), and the entity expects the recovery of the carrying amount of the investment to affect taxable profit. The most common reason for this is the existence of undistributed profits in the investee (although this will not affect investments in associates or joint ventures that are measured at cost). A temporary difference between the carrying amount of the investment and its tax basis is sometimes

referred to as an 'outside basis' difference. It is in addition to the temporary differences relating to the investee's underlying assets and liabilities (sometimes referred to as 'inside basis' differences).

An 'outside basis' difference (temporary difference between the carrying amount of an investment and its tax basis) may arise in various circumstances; for example:

- the existence of undistributed profits of subsidiaries (ie where the subsidiary's profits have been consolidated)
- the existence of undistributed profits of associates or joint ventures where the equity method is applied (ie where the investee's profits have been equity accounted)
- changes in the fair value of investments in associates or joint ventures where the investment is remeasured at fair value (if the fair value model is applied) but no equivalent adjustment is made for tax purposes
- changes in foreign exchange rates when a parent and its investee have different functional currencies (only subsidiaries and associates/joint ventures accounted for using equity accounting)
- a reduction in the carrying amount of an investment in an associate or joint venture to its recoverable amount due to impairment (only where such investments are accounted for using the cost model or equity accounting)
- changes in the tax basis of the investment (eg indexation allowances).

This temporary difference between the carrying amount of an investment and its tax basis in the consolidated financial statements (or parent's individual financial statements where there are no subsidiaries) may differ from the temporary difference associated with the investment in the subsidiary, associate or joint venture in the parent's separate financial statements (if prepared in addition to the primary statements (see Section 9 *Consolidated and Separate Financial Statements*). This is because the carrying amount of the investment may differ between the two sets of financial statements.

Similar additional temporary differences also can arise whenever there are tax consequences of remitting income from one part of an entity to another, for example when there are tax branches that are not separate subsidiaries. Such temporary differences would be dealt with in the same way as temporary differences on investments in subsidiaries.

An entity is required to recognise a deferred tax liability or asset for all temporary differences associated with investments in subsidiaries and interests in associates or joint ventures unless the exception in paragraph 29.16(a) applies (ie where the investment is essentially permanent in duration), unless it is apparent that the temporary difference will reverse in the foreseeable future.

Section 29 of the *IFRS for SMEs* uses the approach for determining deferred tax that was proposed for full IFRS in exposure draft ED/2009/2 *Income Tax* (published in March 2009). The Board's reasoning for including a similar exception to that set out in paragraph 29.16(a) in ED/2009/2 *Income Tax* (see paragraph BC 43 of the Basis for Conclusions on ED/2009/2 *Income Tax*), is that the calculation of the amount of deferred taxes for permanently reinvested unremitted earnings of foreign subsidiaries and joint ventures is so complex that the costs of doing so outweigh the benefits. In the *IFRS for SMEs* the exemption is extended to associates (see paragraph 29.16(a) of Section 29).

In some cases judgement is required to determine whether an investment in a foreign subsidiary, foreign associate or foreign joint venture is essentially permanent in nature.

Examples – investments in foreign subsidiaries

Ex 76 **A parent entity has a foreign subsidiary with a carrying amount (net assets) of CU150,000 in the consolidated financial statements, and a tax basis of CU100,000. The parent entity expects to sell its subsidiary soon after the year end. The capital gains tax rate in the parent entity's jurisdiction is zero.**

Because a nil tax rate applies to any taxable or deductible amounts arising from selling the subsidiary, in practice this is the same as there being no taxable income arising on the recovery of the investment (see the notes below paragraph 29.10). The effect is the same as if the entity were expecting to recover its investment in a subsidiary without affecting taxable profit. Hence, under paragraph 29.10, no deferred tax asset or liability arises for any temporary difference on the investment in the subsidiary.

Note: this would not affect the recognition of deferred tax for temporary differences on the subsidiary's individual assets and liabilities. Deferred tax assets and liabilities that arise on temporary differences on individual assets and liabilities in the subsidiary should be assessed in the context of their recovery or settlement by the subsidiary, not in the context of the recovery of the investment of the subsidiary by the parent.

Ex 77 **A parent entity has a foreign subsidiary with a carrying amount (net assets) of CU150,000 in the consolidated financial statements, and a tax basis of CU100,000. The entity expects to hold on to its investment for the foreseeable future. There are no requirements that would force the subsidiary to pay a dividend, and the parent entity does not expect to require the subsidiary to make a distribution. Instead, the parent entity has set up plans for the undistributed profits to be reinvested to expand the subsidiary's business for the foreseeable future. If the entity sold the subsidiary or received distributions from the subsidiary it would affect taxable profit.**

The parent entity should not recognise a deferred tax liability in respect of the temporary difference of CU50,000 because the foreign investment is essentially permanent, and the temporary difference is not expected to reverse in the foreseeable future.

Example – investments in foreign associates

Ex 78 **An entity accounts for its investments in associates using the equity method (see Section 14 *Investments in Associates*). The entity has an investment in a foreign associate with a carrying amount of CU150,000 and a tax basis of CU100,000 (equal to the initial cost of the investment). The entity expects to hold on to its investment for the foreseeable future. There are no requirements that would force the associate to pay a dividend. Management of the associate have disclosed plans, which have been approved by a majority of shareholders, for undistributed profits to be reinvested to expand the associate's business for the foreseeable future. If the entity were to sell its investment in the associate or received distributions from the associate it would affect taxable profit.**

The parent entity should not recognise a deferred tax liability in respect of the temporary difference of CU50,000 because the foreign investment is essentially

permanent, and the temporary difference is not expected to reverse in the foreseeable future.

In practice, it will be harder to provide evidence of specific plans for reinvestment of the foreign associate's undistributed earnings in order to demonstrate that the investment is essentially of a permanent nature than it would be for investments in foreign subsidiaries. This is because the entity does not have control over the investee, and so it will not be able to set up plans for the undistributed profits of the associate to be reinvested without the agreement of other investors. In addition, without control over the investee, the entity may not be able to gather enough information to support the assumption that the investment is permanent in nature. This will particularly be the case if there is a third party that has control over the associate.

Unless there is a well-evidenced agreement (as in this example) that profits will not be distributed in the foreseeable future, the investor in a foreign associate should normally recognise deferred tax arising on the unremitted earnings of the foreign associate unless there is evidence to the contrary.

[Paragraph 29.16 continued—The following are exceptions to the requirements of paragraph 29.15:]

(b) An entity shall not recognise a deferred tax liability for a temporary difference associated with the initial recognition of goodwill.

Notes

Many tax authorities do not allow reductions in the carrying amount of goodwill as a deductible expense in determining taxable profit. Moreover, in such jurisdictions, the cost of goodwill is often not deductible when a subsidiary disposes of its underlying business. In such jurisdictions, goodwill has a tax basis of nil. Any difference between the carrying amount of goodwill and its tax basis of nil is a temporary difference that is expected to increase taxable profit in the future. However, Section 29 does not permit the recognition of the resulting deferred tax liability.[(2)]

Subsequent reductions in a temporary difference attributable to the initial recognition of goodwill similarly do not result in the recognition of deferred tax balances.

Note: deferred tax liabilities for temporary differences relating to goodwill are recognised to the extent that they do not arise from the initial recognition of goodwill (see example 80).

Examples – goodwill

Ex 79 **In a business combination an entity recognises goodwill of CU200. The tax authorities do not allow reductions in the carrying amount of goodwill as a deductible expense in determining taxable profit. The cost of the goodwill would also not be deductible if the underlying business were to be disposed of. The entity amortises the goodwill over ten years.**

(2) The IASB's reasoning for this exception is that the initial measurement of goodwill is a residual amount arising after measuring at fair value the identifiable assets and liabilities in a business combination. Recognising a deferred tax liability on the initial recognition of goodwill simply adjusts the amount of the residual (paragraph BC38 of the Basis for Conclusions on exposure draft ED/2009/2 *Income Tax*). The same logic applies to the exception in the *IFRS for SMEs*.

The goodwill has a tax basis of nil. Paragraph 29.16(b) prohibits the entity from recognising the resulting deferred tax liability. If the entity subsequently recognises amortisation of CU20 for that goodwill, the temporary difference relating to the goodwill is reduced from CU200 to CU180, with a resulting decrease in the value of the unrecognised deferred tax liability. That decrease in the value of the unrecognised deferred tax liability is also regarded as relating to the initial recognition of the goodwill. Consequently, deferred tax must not be recognised on the temporary difference.

Similarly, if an impairment of the goodwill is recognised, the decrease in the temporary difference and the value of the unrecognised deferred tax liability is also regarded as relating to the initial recognition of the goodwill. Consequently, the deferred tax liability must not be recognised.

Ex 80 **In a business combination an entity recognises goodwill of CU200 that is deductible for tax purposes at a rate of 20 per cent per year, starting in the year of acquisition. If the business to which the goodwill relates is sold, deductions of 100 per cent of cost are available, but all previous deductions received for use must be returned (ie there will be a clawback of all previous deductions for the amortisation of goodwill).**

The tax basis of the goodwill is CU200 on initial recognition and CU160 at the end of the first year. The goodwill is amortised for financial reporting purposes over ten years. At the end of the first year, the carrying amount of goodwill is CU180.

Deferred tax assets and liabilities for temporary differences relating to goodwill are recognised to the extent that they do not arise from the initial recognition of goodwill. A temporary difference of CU20 arises at the end of the first year. Because the carrying amount of the asset (goodwill) is greater than the tax basis, a deferred tax liability arises. For example, if the tax rate is 20 per cent, a deferred tax liability of CU4 must be recognised.

Similarly, if an impairment of the goodwill is recognised, a deferred tax asset or liability is recognised for the temporary difference.

Notes

Exemption for temporary difference arising on initial recognition

Paragraph 29.16 sets out two specific exemptions to the general requirement for recognition of deferred tax assets and liabilities in Section 29, as discussed above. Paragraph BC122 of the Basis for Conclusions on the *IFRS for SMEs* states:

> Section 29 *Income Tax* of the *IFRS for SMEs* uses the approach set out in the Board's exposure draft *Income Tax*, published in March 2009, which proposes a simplified replacement for IAS 12. The only significant measurement difference in the *IFRS for SMEs* as compared with the exposure draft *Income Tax* is where a different tax rate applies to distributed and undistributed income.

Paragraphs 29.14 to 29.16 of the *IFRS for SMEs* are virtually identical to the March 2009 exposure draft. However, the *IFRS for SMEs* does not include an important item of application guidance that was included in the March 2009 exposure draft. That guidance, as set out in paragraph B13(c), refers to setting up a premium or discount as an 'allowance' against, or premium in addition to, the deferred tax asset or deferred tax liability on initial recognition. The effect of recognising such an allowance is to negate the recognition of the related deferred tax asset or liability. Because similar guidance is not included in the *IFRS for SMEs*, some have suggested that it is unclear whether a similar allowance should be recognised. They suggest that because the Board's intent in Section 29 was to adopt the approach in the March 2009 exposure draft, a similar allowance should be recognised. The IASB staff expect to refer this question to the SME Implementation Group for consideration.

29.17 An entity shall recognise changes in a deferred tax liability or deferred tax asset as tax expense in profit or loss, except that a change attributable to an item of income or expense recognised under this IFRS as other comprehensive income shall also be recognised in other comprehensive income.

Notes

Paragraph 29.7 provides that a change in a deferred tax liability or deferred tax asset that is attributable to a transaction recognised under the *IFRS for SMEs* in equity shall also be recognised in equity (see paragraph 29.27).

If an entity does not have any items of income or expense recognised outside profit or loss as other comprehensive income, then all changes in deferred tax assets and liabilities will be recognised in profit or loss unless they relate to an item that has been recognised in equity.

Paragraph 5.4(b) notes that there are three types of income and expenses that may be recognised in other comprehensive income, outside of profit or loss, under the *IFRS for SMEs* when they arise:

- some gains and losses arising on translating the financial statements of a foreign operation (see Section 30 *Foreign Currency Translation*).
- actuarial gains and losses on any defined benefit plans if an entity adopts a policy of recognising them outside profit or loss (see Section 28 *Employee Benefits*)
- some changes in fair values of hedging instruments if an entity applies hedge accounting under Section 12 *Other Financial Instruments Issues*.

A change in a deferred tax asset or liability attributable to one of the three items of other comprehensive income above should also be recognised in other comprehensive income, (see paragraph 5.4(b)).

Measurement of deferred tax

Tax rates

29.18 An entity shall measure a deferred tax liability (asset) using the tax rates and laws that have been enacted or substantively enacted by the reporting date. An entity shall regard tax rates as substantively enacted when future events required by the enactment process historically have not affected the outcome and are unlikely to do so.

Notes

An entity does not consider available information about future changes in tax laws, tax rates or tax status (except those substantively enacted). See notes to paragraph 29.6.

Section 29's requirement to use tax rates and laws that have been enacted or substantively enacted by the reporting date, rather than by the date when the financial statements are authorised for issue, means that enactments or substantive enactments after the reporting date of tax rates and laws are not adjusting events after the end of the reporting period. However, in accordance with Section 32 *Events after the End of the Reporting Period,* changes in tax rates or tax laws enacted or announced after the end of the reporting period that have a significant effect on current and deferred tax assets and liabilities should be disclosed (see paragraph 32.10 and 32.11(h)).

Examples – substantively enacted

Ex 81 **An entity operates in a jurisdiction where a change in tax rate from 25 per cent to 26 per cent was announced on 1 November 20X6 and will take effect from 1 April 20X7. The entity has a year end of 31 March. On 31 March 20X7 the entity has an asset of CU10,000 for interest receivable that will be taxed when cash is received. Assume that the announcement on 1 November 20X6 is considered substantive enactment and that the actual enactment date was on the date that the new tax rate came into effect (1 April 20X7).**

An entity shall measure its deferred tax liability using the tax rates and laws that have been enacted or substantively enacted by the reporting date. Because the new tax rate of 26 per cent that will apply to taxable income from 1 April 20X7 has been substantively enacted by the reporting date (31 March 20X7), it will be used to measure the deferred tax liability because the interest will be taxed after 1 April 20X7.

Deferred tax liability at 31 March 20X7 = CU2,600 (ie CU10,000 × 26%).

Ex 82 **The facts are the same as in example 81. However, the announcement on 1 November 20X6 is not considered to be substantive enactment. Substantive enactment takes place only on the actual enactment date.**

An entity shall measure its deferred tax liability using the tax rates and laws that have been enacted or substantively enacted by the reporting date. Although the new tax rate of 26 per cent is expected to apply to taxable income in 20X7/20X8 it has not been enacted or substantively enacted by the reporting date (31 March 20X7). Hence, it will not be used to measure the deferred tax liability.

Deferred tax liability 31 March 20X7 = CU2,500 (ie CU10,000 × 25%).

Although enactment takes place before the financial statements are authorised for issue, Section 29 precludes using the 26 per cent rate to calculate the deferred tax liability, because this rate was neither enacted nor substantively enacted by 31 March 20X7. If the effect of the change is material to the financial statements, the entity would make the appropriate disclosures for non-adjusting events under Section 32.

29.19 When different tax rates apply to different levels of taxable profit, an entity shall measure deferred tax expense (income) and related deferred tax liabilities (assets) using the average enacted or substantively enacted rates that it expects to be applicable to the taxable profit (tax loss) of the periods in which it expects the deferred tax asset to be realised or the deferred tax liability to be settled.

Notes

Tax rates vary based on level of taxable income

It will normally be necessary to calculate an average tax rate only if the enacted or substantively enacted tax rates are graduated, that is, if different rates apply to different levels of taxable income (see example 83).

The determination of the applicable tax rate may require an estimate of future taxable income for the year(s) in which existing temporary differences or carryforwards will enter into the determination of income tax. That estimate of future income includes:

- income or loss exclusive of reversing temporary differences; and
- reversal of temporary differences.

Tax rates vary between future years

Where the tax rates that will apply to the entity are expected to vary in future years (eg in start-up situations where tax concessions are granted in the early years), it is necessary to anticipate the year in which the temporary difference will reverse, so that the deferred tax asset or liability can be calculated at the appropriate rate (or average rate).

Income tax holidays (including reduced income tax rates)

An income tax holiday is a temporary reduction in, or elimination of, an income tax. Governments usually create tax holidays as incentives to encourage investment or to stimulate growth in selected industries. For example, the government in a particular jurisdiction may forgive (or reduce) income taxes for a specified period if an entity meets certain criteria, such as operating or investing in a particular area of the jurisdiction. Section 29 does not specifically address accounting for tax holidays. Consequently, the entity should determine the tax basis for each asset and liability, and calculate any temporary difference in the usual manner. This means that if temporary differences reverse in a tax holiday period where tax is eliminated, the appropriate tax rate is zero per cent. No deferred tax assets or liabilities would be recognised. If instead a reduced rate applies, the deferred tax assets or liability would be measured at the reduced rate.

A temporary difference is measured at the rate that will apply at the time that it is expected to reverse, and not at the rate that applies when that temporary difference initially arises. Consequently, if a temporary difference arises in a tax holiday but is

expected to reverse after the tax holiday, then the temporary difference should be measured at the standard tax rate that applies to the entity, not at a zero tax rate.

Examples – progressive tax rates

Ex 83 **An entity operates in a jurisdiction where the first CU50,000 of profit is taxed at the rate of 10 per cent and any excess profit over CU50,000 is taxed at 20 per cent.**

If the entity expects to earn annual taxable profit in excess of CU50,000 in the future, the estimated average rate will need to be calculated for each future year in which temporary differences that exist at the reporting date will reverse. In order to determine a single average rate between 10 per cent and 20 per cent, it is necessary to estimate future annual taxable profits, including the effect of the reversal of temporary differences. Section 29 does not require a detailed analysis of net reversals of temporary differences in respect of deferred tax assets and liabilities. However, an entity should be aware of any unusual items that may lead to an abnormal level of taxable profit, or any abnormally large temporary difference that may reverse in a single future year and cause the average rate to be distorted.

Ex 84 **An entity has an item of equipment that is depreciated faster for tax purposes than for financial reporting purposes. On 31 December 20X1 a temporary difference of CU1,000 arises related to this equipment that is expected to increase taxable profit in the future. The temporary difference is expected to reverse in five years' time. In the entity's jurisdiction, tax is payable at 20 per cent on the first CU100,000 of taxable profit earned, 25 per cent on the next CU200,000 of taxable profit earned, 30 per cent on the next CU200,000 of taxable profit earned, and 35 per cent on any remainder (ie excess above CU500,000). In 20X1 the entity earned taxable profit of CU400,000. In 20X6 the entity expects to earn taxable profit of CU650,000.**

In 20X1, the entity earned taxable profit of CU400,000 and therefore paid tax of CU100,000 (ie (CU100,000 × 20%) + (CU200,000 × 25%) + (CU100,000 × 30%)). The average tax rate is 25 per cent (ie CU100,000 ÷ CU400,000).

However, in five years' time, it is expected that the taxable profit will be CU650,000. If the enterprise does earn a taxable profit of CU650,000, then tax of CU182,500 (ie (CU100,000 × 20%) + (CU200,000 × 25%) + (CU200,000 × 30%) + (CU150,000 × 35%) will be payable. This is an average rate of 28.08 per cent.

Consequently, the deferred tax liability will be measured at CU281 (ie CU1,000 × 28.08%).

Ex 85 **An entity has a year end of 31 December. At the end of 20X1, the entity has the following temporary differences:**

- **A temporary difference of CU60,000 that is expected to reduce taxable profit by CU20,000 for the following two years (20X2 and 20X3) and by CU10,000 for the two years after that (20X4 and 20X5). This is due to research and development expenditure that is allowed as a deduction for tax purposes over time (but that is recognised immediately for financial reporting purposes under Section 18 *Intangible Assets Other than Goodwill*).**
- **A temporary difference of CU5,000 that is expected to increase taxable profit by CU5,000 in 20X2. This is due to interest receivable that is taxable only when received.**

The entity operates in a jurisdiction that has a graduated tax rate structure. The graduated tax rates are as follows:

Taxable profit (CU)	*Tax rate*
0 – 50,000	**10%**
50,000.01 – 300,000	**20%**
300,000.01 – 100,000,000	**25%**
Over 100,000,000	**30%**

The projected profits for the next five years (exclusive of reversing temporary differences) are:

20X2	*20X3*	*20X4 and 20X5*	*20X6*
CU260,000	**CU285,000**	**CU350,000**	**CU400,000**

The estimated taxable income (inclusive of reversing temporary difference) for the next four years (20X2—20X5) is:

- 20X2—CU245,000 (ie CU260,000 less CU20,000 research and development + CU5,000 interest)
- 20X3—CU265,000 (ie CU285,000 less CU20,000 research and development)
- 20X4—CU340,000 (ie CU350,000 less CU10,000 research and development)
- 20X5—CU340,000 (ie CU350,000 less CU10,000 research and development).

Only the four years need to be looked at because there are no temporary differences existing on 31 December 20X1 that will reverse in 20X6 or after.

Tax based on scale:

	20X2	*20X3*	*20X4*	*20X5*
10 per cent	CU5,000 (ie CU50,000 × 10%)	CU5,000	CU5,000	CU5,000
20 per cent	CU39,000 (ie (CU245,000 less CU50,000) × 20%)	CU43,000 (ie (CU265,000 less CU50,000) × 20%)	CU50,000 (ie (CU300,000 less CU50,000) × 20%)	CU50,000 (ie (CU300,000 less CU50,000) × 20%)
25 per cent	nil	nil	CU10,000 (ie (CU340,000 less CU300,000) × 25%)	CU10,000 (ie (CU340,000 less CU300,000) × 25%)
Total estimated tax	CU44,000	CU48,000	CU65,000	CU65,000
Estimated average tax rate	17.96% (ie CU44,000 ÷ CU245,000)	18.11% (ie CU48,000 ÷ CU265,000)	19.12% (ie CU65,000 ÷ CU340,000)	19.12% (ie CU65,000 ÷ CU340,000)

The tax rate to apply to the temporary difference from the interest receivable is 17.96 per cent because the temporary difference reverses in 20X2. A deferred tax liability of CU898 (CU5,000 × 17.96%) is recognised.

The deferred tax asset for the research and development costs can be determined by applying the average tax rate in each period to the part of the temporary difference expected to reverse in that period. A deferred tax asset of CU11,038 is recognised (ie (CU20,000 × 17.96%) + (CU20,000 × 18.11%) + (CU10,000 × 19.12%) + (CU10,000 × 19.12%) = CU3,592 + CU3,622 + CU1,912 + CU1,912).

It seems unlikely that a valuation allowance would be required for the deferred tax asset based on the level of expected profits when the temporary difference reverses.

Paragraph 29.29 discusses offset of deferred tax assets and deferred tax liabilities (ie whether the CU11,038 can be offset against the CU898 to recognise a net deferred asset of CU10,140).

29.20 The measurement of deferred tax liabilities and deferred tax assets shall reflect the tax consequences that would follow from the manner in which the entity expects, at the reporting date, to recover or settle the carrying amount of the related assets and liabilities. For example, if the temporary difference arises from an item of income that is expected to be taxable as a capital gain in a future period, the deferred tax expense is measured using the capital gain tax rate.

Notes

In some cases different tax rates apply to profit arising from use of the asset as compared to profit arising on sale of the asset. Section 29 requires the tax basis of an asset to be determined by tax deductions that are available on sale at the reporting date (see paragraph 29.12). In many cases, the same deductions may be available on either use or sale of the asset (see examples 86–91). In other cases deductions for use are materially different from those for sale (see examples 92–97).

Land is usually considered to have an indefinite economic life and, therefore, in accordance with Section 17 *Property, Plant and Equipment,* such land is not depreciated. The carrying amount of such land (regardless of whether it is accounted for in accordance with Section 16 *Investment Property* or Section 17) can be recovered only by sale. Consequently, for the purpose of measuring deferred tax, the expected method of recovery for such land is always sale.

Other items of property, plant and equipment (depreciable assets) are usually recovered through a combination of use and sale. For example, the depreciable amount (ie carrying amount less residual value) is expected to be recovered through use of the asset, and the residual value is expected to be recovered through sale of the asset at the end of the asset's useful life—see examples 90 and 91.

Because the tax basis of an asset equals the amount that would have been deductible in arriving at taxable profit if the carrying amount of the asset had been recovered through sale at the end of the reporting period (see paragraph 29.12(a)) the measurement of a deferred tax asset reflects the tax consequences that would follow from the use of the asset only when the entity expects to recover the carrying amount of the asset through its use and the same deductions are available either on sale or use of the asset. In other words:

- If the deductions available on sale (ie the tax basis) are *not* equal to the deductions available on use, an entity measures deferred tax assets and liabilities at the tax rate that would apply if the asset were sold.[3]
- If the same deductions are available either on sale or on use of the asset, an entity measures the deferred tax asset or liability at the tax rate that would apply to the entity's expected method of recovering the carrying amount of the asset.

Examples – same deductions available on sale and use

Ex 86 **An entity acquires an asset for CU100,000. In accordance with Section 17 *Property, Plant and Equipment* the entity depreciates the asset on the straight-line method over its useful life of 10 years to a nil residual value (ie CU10,000 per year for 10 years).**

In computing its taxable income, the entity depreciates the asset on the straight-line method to a nil residual value over the first five years of the asset's use (ie CU20,000 per year for 5 years). If the asset is sold, deductions of 100 per cent of cost are available, but all previous deductions received for use must be returned (ie a clawback of all previous deductions). The applicable tax rate to use is 30 per cent. On sale the tax rate applicable to the clawback of past allowances is 30 per cent and the tax rate applicable to the excess of the selling price over the CU100,000 cost is 20 per cent.

The entity expects to recover the carrying amount of the asset through use over 10 years.

At the end of the second year the deferred tax liability is CU6,000 (ie using the applicable tax rate of 30% (the expected manner of recovery) × CU20,000 temporary difference).

The temporary difference is the difference between the carrying amount of CU80,000 (ie CU100,000 cost less CU20,000 accumulated depreciation) and the tax basis of CU60,000). The tax basis of the asset is always determined by the consequences of recovery through sale. After two years the tax basis is CU60,000 (ie CU100,000 deduction on sale less clawback of tax depreciation already claimed of CU40,000). There is a temporary difference of CU20,000).

The tax depreciation already claimed is the accumulated tax depreciation deducted in determining the entity's taxable income—calculation: CU100,000 cost ÷ 5 years' tax-deductible life × 2 years of deduction = CU40,000.

Ex 87 **The facts are the same as in example 86. However, in this example, after using the asset for two years, the entity decided to dispose of the asset at its carrying amount of CU80,000 (ie, the entity intends to recover the carrying amount of the asset through sale at the end of the second year).**

The deferred tax liability is CU6,000 (ie 30% tax rate applicable to the clawback on sale (the expected manner of recovery) × CU20,000 temporary difference).

The temporary difference is the difference between the carrying amount of CU80,000 (ie CU100,000 cost less CU20,000 accumulated depreciation) and the tax basis of CU60,000. The tax basis of the asset is always determined by the consequences of

[3] When the deductions available on sale (ie the tax basis) are not equal to the deductions available on use, use of an inconsistent rate would not provide a useful measure of the deferred tax asset or liability (see paragraph BC69 of the Basis for Conclusions on exposure draft ED/2009/2 *Income Tax* on which Section 29 of the *IFRS for SMEs* is based).

recovery through sale. After two years the tax basis is CU60,000 (CU100,000 deduction on sale less clawback of tax depreciation already claimed of CU40,000). There is a temporary difference of CU20,000.

Note: the 20 per cent tax rate is not applicable because it applies only to the sale proceeds in excess of the original cost (of CU100,000) and in this example the temporary difference being measured is the difference between the carrying amount of CU80,000 and the tax basis of CU60,000 both of which are less than the cost of CU100,000.

Ex 88 **On 1 January 20X1 an entity acquires a building for CU100,000. In accordance with Section 16 *Investment Property* the entity accounts for the building at fair value with changes in fair value recognised in profit or loss. At 31 December 20X1 the fair value of the investment property is CU120,000.**

In computing its taxable income the entity depreciates the building on the straight-line method to a nil residual value over the first ten years of its use by others under operating leases from the entity (ie in 20X1 the entity deducted CU10,000 in measuring its taxable profit for the year ended 31 December 20X1). If the building is sold, deductions of 100 per cent of cost are available but all previous deductions received for use must be returned (ie a clawback of all previous deductions). The tax rate applicable to recovery through rental income is 30 per cent. On sale the tax rate applicable to the clawback of past allowances is 30 per cent and the tax rate applicable to the excess of the selling price over the CU100,000 cost is 20 per cent.

At 31 December 20X1 the entity expects to recover the entire carrying amount of the building through sale.

The deferred tax liability is CU7,000—calculation: 30% × CU10,000 (the part of the temporary difference that is expected to be clawed back on sale) + 20% × CU20,000 (the part of the temporary difference that is expected to be subject to tax at 20% when recovered through sale).

The total temporary difference of CU30,000 is the difference between the carrying amount of CU120,000 (fair value at 31 December 20X1) and the tax basis of CU90,000. The tax basis of the asset is always determined by the consequences of recovery through sale. After one year the tax basis is CU90,000 (ie CU100,000 deduction on sale less clawback of tax depreciation already claimed CU10,000).

For measuring the deferred tax liability the temporary difference is analysed into two components—CU10,000 that is expected to be clawed back on sale and CU20,000 that is expected to be subject to tax at 20 per cent.

Ex 89 **The facts are the same as in example 88. However, in this example, at 31 December 20X1 the entity expects to recover the carrying amount of the property entirely through rental income. At the end of the building's economic life the entity intends to scrap the building. No proceeds are expected to arise from that scrapping.**

The deferred tax liability is CU9,000—calculation: 30% (the tax rate applicable to rental income) × CU30,000 temporary difference (the part of the carrying amount that is expected to be recovered through rental income).

The temporary difference of CU30,000 is the difference between the carrying amount of CU120,000 (fair value at 31 December 20X1) and the tax basis of CU90,000. The tax basis of the asset is always determined by the consequences of recovery through sale. After one year the tax basis is CU90,000 (ie CU100,000 deduction on sale less clawback of tax depreciation already claimed of CU10,000).

Ex 90 **The facts are the same as in example 88. However, in this example, at 31 December 20X1 the entity expects to recover CU15,000 of the carrying amount of the building through rental income and CU105,000 of the carrying amount through sale.**

The deferred tax liability is CU8,500—calculation: 30% × CU15,000 part of the carrying amount that is expected to be recovered through rental income (ie from CU120,000 to CU105,000) + 20% × CU5,000 (the part of the carrying amount that when recovered through sale (as expected by the entity) would be subject to tax at 20% when recovered through sale (ie from CU105,000 to CU100,000 cost)) + 30% × CU10,000 (the part of the temporary difference that is expected to be clawed back on sale (ie from CU100,000 cost to CU90,000 tax basis)).

The temporary difference of CU30,000 is the difference between the carrying amount of CU120,000 (fair value at 31 December 20X1) and the tax basis of CU90,000. The tax basis of the asset is always determined by the consequences of recovery through sale. After one year the tax basis is CU90,000 (ie CU100,000 deduction on sale less clawback of tax depreciation already claimed of CU10,000).

Ex 91 **An entity acquires an asset for CU100,000. The cost of the asset is deductible for tax purposes on a straight-line basis over ten years while the asset is being used. On sale, a deduction is available of cost less the tax depreciation previously received. A tax rate of 30 per cent applies to the income generated from the use of the asset and a tax rate of 25 per cent applies to any taxable profit on sale. The entity's financial reporting depreciation is based on an expected useful life of 12 years and a residual value of CU40,000.**

The entity has used the asset for ten years and it expects to use the asset for a further two years and then to sell it.

At the end of the tenth year the asset's depreciated carrying amount is CU50,000 (ie 2 remaining ÷ 12 years useful life × (CU100,000 cost less CU40,000 residual value) + CU40,000 residual value)).

At the end of the tenth year the tax basis of the asset is cost zero, ie CU100,000 cost less tax depreciation CU100,000 (calculation: CU100,000 cost ÷ 10 years tax-deductible life × 10 years of deduction).

At the end of the tenth year the temporary difference is CU50,000 (ie CU50,000 carrying amount less nil tax basis).

The entity expects CU40,000 of the carrying amount to be recovered through sale (ie the residual value) and CU10,000 of the carrying amount (the remaining depreciable amount) to be recovered through use. Consequently, the deferred tax liability can be determined as CU13,000—calculation: CU10,000 (ie CU40,000 expected to be recovered from sale × 25%) + CU3,000 (ie CU10,000 expected to be recovered from use × 30%).

Examples – different deductions available on sale and use

Ex 92 **An entity acquires an asset for CU100,000. In accordance with Section 17 *Property, Plant and Equipment* the entity depreciates the asset on the straight-line method over its useful life of 10 years to a nil residual value (ie CU10,000 per year for 10 years).**

There is no tax depreciation in computing taxable income. If the asset is sold, CU100,000 (ie cost of the asset) is deductible in determining the taxable capital gain or loss on disposal.

The applicable tax rate to use is 30 per cent. The tax rate applicable to capital gains and capital losses is 20 per cent.

At the end of the second year, when the market value of the asset is CU120,000, the entity expects to recover its carrying amount of the asset through sale.

At the end of the second year the deferred tax asset is CU4,000 (ie 20% tax rate applicable to capital loss on sale (the expected manner of recovery) × CU20,000 temporary difference).

The temporary difference is the difference between the carrying amount of CU80,000 (ie CU100,000 cost less CU20,000 accumulated depreciation) and the tax basis of CU100,000 (ie the deduction available on sale). The tax basis of the asset is always determined by the consequences of recovery through sale. There is a temporary difference of CU20,000.

Ex 93 **The facts are the same as in example 92. However, in this example, the entity expects to recover the carrying amount of the asset through use over 10 years.**

At the end of the second year the deferred tax asset is CU4,000 (ie 20% tax rate applicable to sale (even though this is not the expected manner of recovery) × (CU20,000 temporary difference).

The temporary difference is the difference between the carrying amount of CU80,000 (ie CU100,000 cost less CU20,000 accumulated depreciation) and the tax basis of CU100,000, (ie the deduction available on sale). The tax basis of the asset is always determined by the consequences of recovery through sale. There is a temporary difference of CU20,000.

In this case, the entity intends to recover the carrying amount of the asset through its use and therefore in this case there are no tax deductions available to the entity from the use of this asset. If the tax basis of the asset could be determined with reference to its intended use (and if it cannot, see paragraph 29.12(a)) then the tax basis would be zero. Because the tax deductions available from sale (CU100,000) are different to those available from use (nil) the entity measures deferred tax on the asset at the rate applicable to the sale of the asset (ie 20%).

Ex 94 **On 1 January 20X1 an entity acquires a building for CU100,000. In accordance with Section 16 *Investment Property* the entity accounts for the building at fair value with changes in fair value recognised in profit or loss. At 31 December 20X1 the fair value of the investment property is CU120,000.**

There is no tax depreciation in computing taxable income. If the asset is sold, deductions of the lower of 100 per cent of cost and the market value of the asset on the date of sale are available. The applicable tax rate to use is 30 per cent. The tax

rate applicable to the excess of the selling price over the CU100,000 cost is 20 per cent.

At 31 December 20X1 the entity expects to recover the entire carrying amount of the building through sale.

The deferred tax liability is CU4,000—calculation: 20% × CU20,000 (the temporary difference is expected to be subject to tax at 20% when recovered through sale).

The temporary difference of CU20,000 is the difference between the carrying amount of CU120,000 (fair value at 31 December 20X1) and the tax basis of CU100,000. The tax basis of the asset is always determined by the consequences of recovery through sale (ie CU100,000).

Ex 95 **The facts are the same as in example 94. However, in this example, at 31 December 20X1 the entity expects to recover the carrying amount of the property entirely through rental income. At the end of the building's economic life the entity intends to scrap the building. No proceeds are expected to arise from that scrapping.**

As in example 94 the deferred tax liability is CU4,000—calculation: 20% × CU20,000 temporary difference (ie CU120,000 carrying amount).

The temporary difference of CU20,000 is the difference between the carrying amount of CU120,000 (fair value at 31 December 20X1) and the tax basis of CU100,000. The tax basis of the asset is always determined by the consequences of recovery through sale (ie CU100,000).

In this case, the entity intends to recover the carrying amount of the asset through its use (ie by rental to others) and there are no tax deductions available to the entity for this method of recovery. If the tax basis of the building could be determined with reference to its intended use (and if it cannot, see paragraph 29.12(a)) then the tax basis would be zero. Because the tax deductions available from sale (CU100,000) are different to those available from use (nil) the entity measures deferred tax on the building at the rate applicable to the sale of the building (ie 20%).

Ex 96 **On 1 January 20X1 an entity acquires a building for CU100,000. In accordance with Section 16 *Investment Property* the entity accounts for the building at fair value with changes in fair value recognised in profit or loss. At 31 December 20X1 the fair value of the investment property is CU120,000.**

In computing its taxable income the entity depreciates the building on the straight-line method to a nil residual value over the first ten years of its use by others under operating leases from the entity (ie in 20X1 the entity deducted CU10,000 in estimating its taxable profit for the year ended 31 December 20X1). If the building is sold, deductions of 100 per cent of cost increased by a specified price index established by the tax authority (5 per cent in 20X1) are available, but all previous deductions received for use must be returned (ie a clawback of all previous deductions). At 31 December 20X1 the tax rate applicable to recovery through rental income is 30 per cent. On sale the tax rate applicable to the clawback of past allowances is 30 per cent and the tax rate applicable to the excess

of the selling price over the CU105,000 (ie CU100,000 cost + 5% of CU100,000 indexation adjustment) is 20 per cent.

At 31 December 20X1 the entity expects to recover the entire carrying amount of the building through sale.

At 31 December 20X1 the deferred tax liability is CU6,000—calculation: 20% × CU15,000 taxable capital gain (ie CU120,000 carrying amount less CU105,000 adjusted cost) + 30% × CU10,000 clawback of past deductions.

The temporary difference of CU25,000 is the difference between the carrying amount of CU120,000 (fair value at 31 December 20X1) and the tax basis of CU95,000. The tax basis of the asset is always determined by the consequences of recovery through sale (ie CU105,000 adjusted cost less CU10,000 clawback of past allowances).

Ex 97 **The facts are the same as in example 96. However, in this example, the entity expects to recover the carrying amount of the asset through use over 50 years. At the end of 50 years the entity intends to scrap the building.**

At 31 December 20X1 the deferred tax liability is CU6,000—calculation: 20% × CU15,000 taxable capital gain (ie CU120,000 carrying amount less CU105,000 adjusted cost) + 30% × CU10,000 clawback of past deductions.

The temporary difference of CU25,000 is the difference between the carrying amount of CU120,000 (fair value at 31 December 20X1) and the tax basis of CU95,000. The tax basis of the asset is always determined by the consequences of recovery through sale (ie CU105,000 adjusted cost less CU10,000 clawback of past allowances).

In this case, the entity intends to recover the carrying amount of the asset through its use and therefore in this case tax deductions of CU90,000 are available to the entity from the use of this asset. If the tax basis of the asset could be determined with reference to its intended use (and if it cannot, see paragraph 29.12(a)) then the tax basis would be CU90,000. Because the tax deductions available from sale (CU95,000) are different to those available from use (CU90,000) the entity measures deferred tax on the asset at the rates applicable to the sale of the asset (ie 30% for the CU10,000 clawback of past allowances and 20% for the CU15,000 taxable capital gain).

Valuation allowance

29.21 An entity shall recognise a valuation allowance against deferred tax assets so that the net carrying amount equals the highest amount that is more likely than not to be recovered based on current or future taxable profit.

Notes

Sources of taxable profit

Deferred tax assets represent future tax benefits from temporary differences that are expected to reduce taxable profit in the future, and the carryforward of unused tax losses and tax credits. Future realisation of the tax benefit of a temporary difference or carryforward of unused tax losses or tax credits depends on the existence of sufficient taxable profit of the appropriate character (eg taxable income or capital gain) in the

period in which those temporary differences reverse, and within the carryback or carryforward period available under the tax law for tax losses or tax credits. Taxable income for the realisation of the deferred tax asset can come from future operations, past operations or future reversals of temporary differences that are expected to increase taxable profit in the future.

An entity shall recognise a valuation allowance if, on the basis of the available evidence, it is more likely than not that there will not be sufficient taxable profit to realise the tax benefit. The deferred tax asset less the valuation allowance equals the highest amount that is more likely than not to be realisable against taxable profit. Showing the full deferred tax asset with a valuation allowance set off against it provides more information than merely showing the net amount as it provides information to users about the changes in the deferred tax asset and about the availability of taxable income for realising the deferred tax asset.

The *IFRS for SMEs* does not require detailed forecasts, projections, or other analyses to be prepared to justify not recognising a valuation allowance. The extent of the analysis is a matter of judgment. The greater the doubt that the deferred tax asset can be realised, the more significant the analysis should generally be.

An entity shall use judgement in considering the relative effect of negative and positive evidence. The weight given to the potential effect of negative and positive evidence shall be commensurate with the extent to which it can be objectively verified. The more negative evidence that exists, the more positive evidence is necessary and the more difficult it is to conclude that the valuation allowance should be less than the full amount of the deferred tax asset.

Examples – existing temporary differences expected to increase taxable profit in future

Ex 98 **An entity has CU100,000 of temporary differences that are expected to increase taxable profit in the next ten years and temporary differences that are expected to reduce taxable profit in the next few years of CU10,000. In the jurisdiction, losses may be carried back 3 years and carried forward 15 years.**

A deferred tax asset would be recorded for the CU10,000. No valuation allowance would be necessary because the amount of temporary differences available is expected to be enough to increase taxable profit.

Note: care should be taken, however, where there are significant cumulative losses. In this case it may not be possible for the deferred tax asset recognised for temporary differences expected to reduce taxable profit, and the deferred tax asset for the cumulative loss, to both be fully realised against the CU100,000 of temporary differences expected to increase taxable profit. In this case a valuation allowance may still need to be recognised against the deferred tax assets. This applies unless the deferred tax assets are expected to be realisable in another way, for example from future taxable profits. However, it may be difficult to justify that an entity will have sufficient future taxable profits if it has significant cumulative losses.

Ex 99 **An entity incurs a CU2,000 taxable loss in 20X5. Tax law permits loss carryforwards to reduce taxable profit in future years. Revenue on a long-term contract of CU4,000 was recognised in 20X5 under the percentage-of-completion method for**

financial reporting purposes. Because the completed contract method is applied for tax purposes, no revenue was included in taxable profit for 20X5. The contract is expected to be completed in 20X6.

In 20X5 a temporary difference of CU4,000 arises from revenue recognised on the long-term construction contract in 20X5 that will be taxed only in 20X6. Because the reversal of the temporary difference is expected to occur next year (ie in 20X6), when the contract is completed, sufficient taxable amounts are expected to be present to enable use of the loss carryforward. Consequently, a valuation allowance might not be necessary in this situation even if negative evidence is present, such as a history of recent losses.

Example – tax planning strategy

Ex 100 **An entity has tax losses carried forward of CU200,000 and is not expected to return to profitability in the next few years. The entity has negligible temporary differences that are expected to increase taxable profit in the future.**

The entity owns two office buildings together with their plots of land, which are measured at depreciated cost in accordance with Section 17 *Property, Plant and Equipment*. The first building has plenty of excess space. The entity could sell the second building and move all its staff into the first building. The second building has a depreciated cost of CU300,000 and a tax basis of CU280,000. However, the market value of the property is CU1,000,000. The entity has a tax planning strategy to sell the second building and land if necessary to prevent the carried-forward losses from expiring unused. The tax rate is 40 per cent.

The entity should record a deferred tax asset of CU80,000 (ie CU200,000 tax losses carried forward × 40%). Judgement is required to determine whether a valuation allowance should be recorded. This is because, despite the negative evidence (operating losses and negligible temporary differences expected to increase taxable profit in the future), it might not be necessary in this situation because, owing to the second office building, there is an excess of unrecognised asset value over the tax basis of the entity's net assets which is sufficient to realise the full deferred tax asset.

Examples – calculation of a valuation allowance

Ex 101 **At 31 December 20X8 (its financial year end) an entity has temporary differences that are expected to reduce taxable profit in the future by CU120,000. The tax rate is 20 per cent. Based on available evidence, the entity's management concludes that it is more likely than not that all sources will not result in future taxable income sufficient to realise an income tax benefit of more than CU30,000 (ie 25 per cent of the temporary differences expected to reduce taxable profit in the future).**
No deferred tax assets were recognised in previous years, carryback of tax losses is not permitted and the profit for 20X8 was close to zero. Losses may be carried forward for ten years.

On 31 December 20X8 the entity records a deferred tax asset of CU24,000 (ie CU120,000 × 20%) and a valuation allowance of CU18,000 (ie (CU120,000 less CU30,000) × 20%).

The journal entries on 31 December 20X8 are:

Dr	Deferred tax asset	CU24,000	
	Cr Valuation allowance		CU18,000
	Cr Profit or loss—income tax (deferred tax)		CU6,000

To recognise valuation allowance.

The income tax benefit (deferred tax) of CU6,000 represents that portion of the deferred income tax asset that is more likely than not to be realisable.

Ex 102 **An entity has a 31 December financial year end. The entity estimated its tax loss for the year ended 31 December 20X0 at CU10,000. It identified the following temporary differences on 31 December 20X0:**

- **CU8,000 from the accelerated tax depreciation of machinery that is expected to increase taxable profit (or decrease tax losses) in the future. CU4,000 is expected to reverse in each of 20X1 and 20X2.**
- **CU5,500 from research and development expenditure that is allowed as a deduction for tax purposes on a straight-line basis over five years, but is recognised as an expense in accounting profit immediately as it is incurred, in accordance with Section 18. It is expected to reduce taxable profit (or increase tax losses) in the future by CU1,100 per year**.

Tax is payable at 25 per cent. Management expects that the entity will not have taxable profit in the foreseeable future. Tax losses can be carried forward ten years, but may not be carried back to prior years.

Anticipated reversals of temporary differences:

	20X1 CU	*20X2 CU*	*20X3 CU*	*20X4 CU*	*20X5 CU*
Accelerated tax depreciation	(4,000)	(4,000)	–	–	–
R&D expenditure	1,100	1,100	1,100	1,100	1,100

In each of 20X1 and 20X2, the taxable temporary difference of CU4,000 relating to the accelerated tax depreciation will reverse. This will result in taxable amounts of CU4,000 against which the entity can use the deductible temporary difference of CU1,100 relating to R&D expenditure and also a tax loss carryforward of CU2,900 (CU4,000 − CU1,100) each year. However, in 20X3 to 20X5, the entity will not have any sources of taxable profit available to offset the deductible temporary difference of CU1,100 each year and the remaining tax loss carryforward of CU4,200 (CU10,000 − CU2,900 x 2 years).

On 31 December 20X0, the entity recognises a deferred tax liability in respect of the accelerated tax depreciation of CU2,000 (ie CU8,000 × 25%) and a deferred tax asset in respect of the research and development costs of CU1,375 (ie CU5,500 × 25%) together with a deferred tax asset in respect of the tax loss of CU2,500 (ie CU10,000 × 25%).

However, on 31 December 20X0, because it is more likely than not that the entity will not be able to use the deductible temporary difference of CU3,300 (CU1,100 x 3 years) and the tax loss carryforward of CU4,200, the entity recognises a valuation allowance of CU1,875 (ie CU3,300 at 25% plus CU4,200 at 25%) against the deferred tax assets.

This applies unless other expected sources of taxable profits or tax planning opportunities are identified in order to support a lower valuation allowance. In this example this seems unlikely.

29.22 An entity shall review the net carrying amount of a deferred tax asset at each reporting date and shall adjust the valuation allowance to reflect the current assessment of future taxable profits. Such adjustment shall be recognised in profit or loss, except that an adjustment attributable to an item of income or expense recognised in accordance with this IFRS as other comprehensive income shall also be recognised in other comprehensive income.

Notes

At the end of each reporting period, an entity shall adjust the amount of the valuation allowance to the extent that it has become more likely than not that future taxable profit will allow more or less of the deferred tax asset to be realised. For example, a change in trading conditions may make it more likely or less likely that the entity can generate sufficient taxable profit in the future for the deferred tax asset to be realised.

An entity will also need to reassess deferred tax assets at the date of a business combination. This is because, as a result of a business combination, the probability of there being sufficient taxable profit to realise a pre-acquisition deferred tax asset of the acquirer could change. For example, this may be due to the acquirer being able to use the benefit of its unused tax losses against the future taxable profit of the acquiree. In such cases, the acquirer recognises a change in the related valuation allowance in the period of the business combination, but does not include it in the accounting for the business combination. Consequently, the acquirer does not take the change into account in measuring the goodwill or bargain purchase gain that it recognises from the business combination (see example 104).

Examples – calculation of a valuation allowance

Ex 103 **The facts are the same as in example 101. At 31 December 20X9 the entity's temporary differences that are expected to reduce taxable profit in the future are CU100,000 and, because of operating losses in 20X9, the entity now has an unused tax loss carryforward of CU84,000. Based on available evidence, the entity's management concludes that it is more likely than not that all sources will only result in future taxable income sufficient to realise an income tax benefit of CU20,000.**

The total of the operating loss carryforward (CU84,000) plus the amount of the future deductible temporary difference (CU100,000) is CU184,000. A deferred tax asset of CU36,800 (ie CU184,000 × 20%) is recognised at 31 December 20X9.

A valuation allowance equal to CU32,800 is required (ie (CU184,000 less CU20,000) × 20%). The balance in the allowance account of CU18,000 must be increased by CU14,800 (ie CU32,800 less CU18,000).

The journal entries on initial recognition are:

Dr	Deferred tax asset	CU12,800[(a)]	
Dr	Profit or loss—income tax (deferred tax)	CU2,000[(b)]	
	Cr Valuation allowance		CU14,800

To recognise valuation allowance.

(a) CU36,800 less CU24,000

(b) The deferred tax expense of CU2,000 represents the net amount from the CU12,800 increase in the deferred income tax asset and the CU14,800 increase in the valuation allowance.

Ex 104 **A group has unused tax losses carried forward from prior periods of CU100,000. In 20X5 a valuation allowance was set against 50 per cent of the deferred tax asset recognised for such unused tax losses, because it was more likely than not that some losses would expire unused.**

In 20X6 the group acquired 100 per cent of the share capital of another entity (subsidiary). The subsidiary is highly profitable and maintains stable profit margins. The acquiree's existing contracts are expected to produce sufficient taxable income to enable use of all of the loss carryforwards.

The group is taxed on a consolidated basis (ie it files a consolidated tax return).

As a result of the business combination, the probability of there being sufficient taxable profit to realise the deferred tax asset of the group has changed. The group may use the benefit of its unused tax losses against the future taxable profit of the acquiree. Consequently, the group would reverse the related valuation allowance in 20X6 (ie eliminate it). Such a reduction does not affect the accounting for the business combination.

Note: if the group is taxed on an individual entity/operation basis (ie the group files separate tax returns for different operations), it may still be possible for the group to use the benefit of its unused tax losses against the future taxable profit of the acquiree if the relevant tax laws of the jurisdiction permit it. For example, some jurisdictions permit group relief. This effectively permits the transfer of unused tax losses between entities in the same group. However, if the group entities that have carryforward losses are in tax jurisdictions in which group relief (or a similar relief) is prohibited, the valuation allowances would still need to be recognised against the deferred asset for those losses.

Measurement of both current and deferred tax

29.23 An entity shall not discount current or deferred tax assets and liabilities.

Notes

Discounting deferred tax assets and liabilities would require detailed scheduling of the timing of the reversal of each temporary difference. In many cases such scheduling is impracticable or highly complex, and so discounting is prohibited under Section 29.

29.24 Uncertainty about whether the tax authorities will accept the amounts reported to them by the entity affects the amount of current tax and deferred tax. An entity shall measure current and deferred tax assets and liabilities using the probability-weighted average amount of all the possible outcomes, assuming that the tax authorities will review the amounts reported and have full knowledge of all relevant information. Changes in the probability-weighted average amount of all possible outcomes shall be based on new information, not a new interpretation by the entity of previously available information.

Notes

Sometimes uncertainties arise regarding the appropriate tax treatment for items. In such cases there may be doubt as to whether the treatment adopted by the entity when preparing the tax return will ultimately be supported on investigation by the relevant tax authority. These types of uncertainties are sometimes referred to as 'uncertain tax positions'.

Where management has doubt over the appropriate tax treatment, the entity must include this in the measurement of current and deferred tax, unless it is immaterial. The assessment of the different outcomes and associated probabilities required under paragraph 29.24 may be a subjective process in some cases. If the amounts involved are significant and management do not have suitable expertise, an entity may need to seek expert tax advice.

Example – uncertain tax positions

Ex 105 **In 20X1 an entity reports taxable profit of CU1,000 to the tax authority. The management of the entity considers the effect of uncertainty over some of the amounts reported in the tax return to be immaterial except in relation to two deductions. The two deductions are as follows:**

- **Entertainment expenses: the entity believes that CU3,000 of the entertainment expenses incurred in 20X1 is deductible. Hence the entity has made a claim for this on the tax return. Because there is some uncertainty about which entertainment expenses are deductible in the jurisdiction, management feels that there is a small chance that the claim may fail.**
- **Employee benefits: the entity believes that CU900 of a particular type of benefit provided to employees is deductible. Hence the entity has made a claim for this on the tax return. However, management is concerned that the tax authority may consider that CU700 of the expenditure is equivalent to a gift to the employees, which is not tax-deductible in the jurisdiction. Consequently, management believes that it is possible only CU200 of the claim will be allowed.**

The entity assesses the possible outcomes of those deductions as follows:

Possible outcomes	Probability of outcome occurring	Probability-weighted outcome
Deduction for entertainment expenses (reported amount CU3,000)		
CU3,000	80%	CU2,400
CU0	20%	CU0

Probability-weighted average		**CU2,400**
Deduction for employee benefits (reported amount CU900)		
CU900	**60%**	**CU540**
CU200	**40%**	**CU80**
Probability-weighted average		**CU620**

The taxable profit before deducting any amount for the two uncertain expenses is CU4,900.

The entity measures its current tax liability based on taxable profit of CU1,880 (ie CU4,900 less (CU2,400 entertainment expenses + CU620 employee benefits).

29.25 In some jurisdictions, income tax is payable at a higher or lower rate if part or all of the profit or retained earnings is paid out as a dividend to shareholders of the entity. In other jurisdictions, income tax may be refundable or payable if part or all of the profit or retained earnings is paid out as a dividend to shareholders of the entity. In both of those circumstances, an entity shall measure current and deferred taxes at the tax rate applicable to undistributed profits until the entity recognises a liability to pay a dividend. When the entity recognises a liability to pay a dividend, it shall recognise the resulting current or deferred tax liability (asset), and the related tax expense (income).

Notes

Measurement complications can arise when distributed income is taxed at a rate that is different from the tax rate on undistributed income. In such situations, deferred tax assets and liabilities should be measured using the tax rates on undistributed profits (ie the entity does not anticipate any future dividends). Income tax consequences of a dividend should only be accounted for when the dividend is recognised as a liability in the financial statements. Any tax consequences that may follow as a result of payment of a dividend are recognised at the time when the dividend is subsequently declared and recognised as a liability. This treatment is consistent with paragraph 32.8 of Section 32 *Events after the End of the Reporting Period* which states that '*if an entity declares dividends to holders of its equity instruments after the end of the reporting period, the entity shall not recognise those dividends as a liability at the end of the reporting period*". In conformity with this, paragraph 29.25 requires any tax consequences that may follow as a result of payment of a dividend to be recognised only when the dividend is subsequently declared and recognised as a liability.

Examples – tax rate

Ex 106 **An entity operates in a jurisdiction where income taxes are payable at a higher rate on undistributed profits (50 per cent) with an amount being refundable when profits are distributed. The tax rate on distributed profits is 35 per cent.**

On 31 December 20X1 the entity expects to propose dividends in March 20X2 of approximately CU10,000 for the year ended 20X1. The financial statements will be authorised for issue in April 20X2. Taxable income for 20X1 is CU100,000.
On 31 December 20X1 the entity has temporary differences that are expected to increase taxable profit in the future of CU40,000.

At 31 December 20X0 the entity had no temporary differences.

The entity recognises a current tax liability and a current income tax expense for the year ended 31 December 20X1 of CU50,000 (ie CU100,000 × 50%) based on the tax rate applicable to undistributed profits. No asset is recognised for the amount potentially recoverable as a result of future dividends because the dividends are not declared before the reporting date. They are declared before the financial statements are authorised for issue, but the financial statements are not adjusted.

The entity also recognises a deferred tax liability and deferred tax expense of CU20,000 (ie CU40,000 × 50%) representing the additional income tax that the entity will pay, based on the tax rate applicable to undistributed profits, when the temporary differences reverse.

Ex 107 **The facts are the same as in example 106. The current tax liability of CU50,000 is paid on 1 March 20X2. Subsequently, on 15 March 20X2, the entity declares a dividend payable of CU10,000 from operating profits for the year ended 31 December 20X1.**

On 15 March 20X2 the entity recognises a liability for the dividends for CU10,000. On the same date, the entity also recognises a current asset for the recovery of income taxes of CU1,500 (15% × CU10,000 dividends recognised as a liability). The entity recognises the CU1,500 as a current tax asset and as a reduction of current income tax expense for the year ended 31 December 20X2.

The entity continues to recognise deferred tax assets and liabilities using the undistributed rate.

Note: it is more appropriate to recognise the incremental tax effect of the dividend payment (in this example the additional tax of CU1,500) in profit or loss, rather than in equity, even though the dividend payment is charged to equity. This is because the income tax consequences of dividends are more directly linked to past transactions or events than they are linked to distributions to owners (see paragraph 29.27 for allocation requirements).

Withholding tax on dividends

29.26 When an entity pays dividends to its shareholders, it may be required to pay a portion of the dividends to taxation authorities on behalf of shareholders. Such an amount paid or payable to taxation authorities is charged to equity as a part of the dividends.

Notes

The withholding tax is not attributable to the entity paying the dividend. The entity paying the dividend is effectively acting as an agent in collecting tax. Consequently, the

total amount of the dividend inclusive of that paid to the tax authorities would be shown as a dividend in the accounts of the payer.

Example – withholding tax on dividends

Ex 108 **An entity declares a dividend of CU5,000 to its shareholders (all shareholders have small shareholdings). The entity operates in a jurisdiction where it is required to withhold 25 per cent of the value of the dividend payable to shareholders and pay it to the tax authorities on behalf of those shareholders.**

The entity would make the following journal entries when it declares the dividend to shareholders:

Dr	Retained earnings	CU5,000	
	Cr Payable (amount due to shareholders)		CU3,750
	Cr Payable (amount due to tax authority)		CU1,250

To recognise dividends payable to shareholders.

The entity recognises a financial liability for the amount withheld that will need to be paid to the tax authorities of CU1,250 (ie CU5,000 × 25%) and the net dividend payable to the shareholders of CU3,750 (ie CU5,000 less CU1,250).

Presentation

Allocation in comprehensive income and equity

29.27 An entity shall recognise tax expense in the same component of total comprehensive income (ie continuing operations, **discontinued operations**, or other comprehensive income) or equity as the transaction or other event that resulted in the tax expense.

Notes

Transaction or event recognised in other comprehensive income

The notes and the example supporting paragraph 29.7 explain how this requirement is applied for current tax expense resulting from transactions or other events that are recognised as other comprehensive income.

The notes supporting paragraph 29.17 explain how this requirement is applied for deferred tax expense resulting from transactions or other events that are recognised as other comprehensive income.

Entities need only address the allocation of the total tax expense because Section 29 does not require an analysis of total tax expense in other comprehensive income into current and deferred tax.

Transaction or event recognised in equity

Current and deferred tax expense should be charged or credited directly to equity if the tax relates to items that are credited or charged directly to equity, either in the same period or a different period,. Three examples of items on which deferred tax are credited or charged directly to equity are:

- an adjustment to opening retained earnings resulting from either a change in accounting policy that is accounted for retrospectively or the correction of an error. (Section 10 *Accounting Policies, Estimates and Errors*)
- the initial recognition of the equity component on classification of a compound financial instrument (Section 22 *Liabilities and Equity*)
- the issue of shares (Section 22). See example 109.

Transaction or event recognised in discontinued operations

A discontinued operation is defined as a component of an entity that has either been disposed of, or is held for sale, and

(a) represents a separate major line of business or geographical area of operations'

(b) is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations' or

(c) is a subsidiary acquired exclusively with a view to resale.

Paragraph 5.5 of Section 5 requires entities with discontinued operations to include discontinued operations as a separate line item in the statement of comprehensive income net of the related income tax. Consequently. any income tax on the profit or loss of a discontinued operation, or on the sale of a discontinued operation, or on movements in deferred tax assets or liabilities relating to assets and liabilities of a component whilst it is classified as discontinued (eg due to change in value of the assets and liabilities while the component is considered to be held for sale) should be allocated to discontinued operations.

Module 5 *Statement of Comprehensive Income and Income Statement* illustrates the identification and disclosure of discontinued operations.

Example – allocation

Ex 109 **An entity issues new shares. In the entity's jurisdiction, transaction costs associated with the issue of the shares are deductible for tax purposes in the period in which they are incurred.**

Paragraph 22.9 of Section 22 requires that "*an entity shall account for the transaction costs of an equity transaction as a deduction from equity, net of any related income tax benefit*" (ie the reduction in tax is charged directly to equity in the same place as the transaction costs).

Current/non-current distinction

29.28 When an entity presents current and non-current assets, and current and non-current liabilities, as separate classifications in its statement of financial position, it shall not classify any deferred tax assets (liabilities) as current assets (liabilities).

Note

All deferred tax assets and all deferred tax liabilities are classified as non-current.

Offsetting

29.29 An entity shall offset current tax assets and current tax liabilities, or offset deferred tax assets and deferred tax liabilities, only when it has a legally enforceable right to set off the amounts and it expects either to settle on a net basis or to realise the asset and settle the liability simultaneously.

Notes

Offset of current tax assets and liabilities

An entity may have a legally enforceable right to set off a current tax asset against a current tax liability when they relate to income taxes levied by the same taxation authority and the taxation authority permits the entity to make or receive a single net payment.

In consolidated financial statements, a current tax asset of one entity in a group is offset against a current tax liability of another entity in the group, if the entities concerned have a legally enforceable right to make or receive a single net payment, and if the entities also expect to make or receive such a net payment or to recover the asset and settle the liability simultaneously.

Offset of deferred tax assets and liabilities

Deferred tax assets and liabilities arising within the same legal entity can generally be offset, assuming that it is also a single taxable entity. However, an example where this would not be the case is if a taxable entity has unused capital losses that can only be carried forward and used against future capital gains. In this example, the deferred tax asset that relates to the losses would only be offset against deferred tax liabilities to the extent that the deferred tax liabilities relate to unrealised capital gains.

The requirement to realise the deferred tax asset and settle the deferred tax liability simultaneously is important for deferred tax. Offset of specifically identified deferred tax balances should only take place if the temporary difference giving rise to a deferred tax asset reverses before, or at the same time as, the temporary differences that create a deferred tax liability. If those giving rise to the liability reverse first, there will be a requirement to pay tax before there is any entitlement to recover tax.

The requirement for balances to be levied by the same taxation authority generally prevents the offset of deferred tax assets and liabilities of group entities in different

jurisdictions. Even for group entities operating in one jurisdiction, the taxation authorities often do not permit net settlement between different taxable entities.

Consequently, in preparing consolidated financial statements, the deferred tax assets of the separate entities are generally aggregated together. The deferred tax liabilities of the separate entities are generally also aggregated but there may be no further offset of the deferred tax assets with the deferred tax liabilities.

Offset in statement of comprehensive income

Note: the ability to offset the amounts in the statement of financial position does not override the requirement for the tax expense (or benefit) to be appropriately classified within the appropriate component of comprehensive income or equity.

Disclosures

29.30 An entity shall disclose information that enables users of its financial statements to evaluate the nature and financial effect of the current and deferred tax consequences of recognised transactions and other events.

Notes

In addition to the requirement in paragraph 29.30, paragraph 3.2 requires additional disclosures when compliance with the specific requirements in the *IFRS for SMEs* is insufficient to enable users to understand the effect of particular transactions, other events and conditions on the entity's financial position and financial performance. Consequently, paragraphs 29.31 and 29.32 prescribe the minimum disclosures that are necessary under Section 29. An entity should also provide information about its circumstances in the note disclosures, if such information would be helpful to users of the financial statements.

Example – disclosure required by paragraph 29.30

Ex 110 **An entity could disclosure income tax as follows:**

Note 2 Accounting policies

Income tax

Income tax represents the sum of current tax and deferred tax.

Current tax

Current tax for the year is based on taxable profit for the year. Current tax is calculated using tax rates that have been enacted or substantively enacted by the end of the reporting period.

A formal government announcement of changes in tax rates or tax laws is considered substantive enactment in the two tax jurisdictions in which the group operates.

Deferred tax

A deferred tax liability is recognised for all temporary differences that are expected to

increase taxable profit in the future. Deferred tax assets are recognised for all temporary differences that are expected to reduce taxable profit in the future, and the carryforward of unused tax losses and unused tax credits.

Deferred tax is calculated at the tax rates that are expected to apply to the taxable profit (tax loss) of the periods in which it expects the deferred tax asset to be realised (the deferred tax liability to be settled), on the basis of tax rates that have been enacted or substantively enacted by the end of the reporting period.

A valuation allowance is recognised against deferred tax assets so that the net amount equals the highest amount that is more likely than not to be realised on the basis of current or future taxable profit. The net carrying amount of deferred tax assets is reviewed at each reporting date and is adjusted to reflect the current assessment of future taxable profits.

Income tax (current and deferred) is recognised in profit or loss, other comprehensive income or equity depending on the transaction or other event that resulted in the tax expense.

29.31 An entity shall disclose separately the major components of tax expense (income). Such components of tax expense (income) may include:

(a) current tax expense (income).

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

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

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

(e) the effect on deferred tax expense arising from a change in the effect of the possible outcomes of a review by the tax authorities (see paragraph 29.24).

(f) adjustments to deferred tax expense arising from a change in the tax status of the entity or its shareholders.

(g) any change in the valuation allowance (see paragraphs 29.21 and 29.22).

(h) the amount of tax expense relating to changes in accounting policies and errors (see Section 10 *Accounting Policies, Estimates and Errors*).

Notes

The example below illustrates the disclosure required by paragraph 29.31. Some line items have been included even though there are no amounts recognised for them in the current and prior year. They are included in the example only to illustrate their position. In practice, if an entity has a zero amount for such items in all years presented in the financial statements, it may omit that line item from the note disclosure.

Example 111 assumes the entity does not have any income tax expense allocated to other comprehensive income, equity or related to discontinued operations.

Example – disclosure required by paragraph 29.31

Ex 111 **An entity could disclose income tax expense as follows:**

Note 10 Income tax expense

Tax expense comprises:

	20X2 CU	*20X1* CU	*Reference to* IFRS for SMEs
Current tax expense	44,100	35,000	29.31(a)
Adjustments recognised in period for current tax of prior periods	(100)	–	29.31(b)
Amount of deferred tax expense relating to the origination and reversal of temporary differences	4,500	2,000	29.31(c)
Amount of deferred tax expense (income) relating to changes in tax rates	–	–	29.31(d)
Effect on deferred tax expense arising from a change in the effect of the possible outcomes of a review by the tax authorities	–	–	29.31(e)
Adjustments to deferred tax expense arising from a change in the tax status of the entity or its shareholders	–	–	29.31(f)
Increase in the valuation allowance	500	–	29.31(g)
Amount of tax expense relating to changes in accounting policies and errors	–	–	29.31(h)
Total tax expense	**49,000**	**37,000**	

29.32 An entity shall disclose the following separately:

(a) the aggregate current and deferred tax relating to items that are recognised as items of other comprehensive income.

(b) an explanation of the significant differences in amounts presented in the statement of comprehensive income and amounts reported to tax authorities.

(c) an explanation of changes in the applicable tax rate(s) compared with the previous reporting period.

(d) for each type of temporary difference and for each type of unused tax losses and tax credits:

(i) the amount of deferred tax liabilities, deferred tax assets and valuation allowances at the end of the reporting period, and

(ii) an analysis of the change in deferred tax liabilities, deferred tax assets and valuation allowances during the period.

(e) the expiry date, if any, of temporary differences, unused tax losses and unused tax credits.

(f) in the circumstances described in paragraph 29.25, an explanation of the nature of the potential income tax consequences that would result from the payment of dividends to its shareholders.

Notes

The example below illustrates one way of presenting the disclosures required by paragraph 29.32.

Example – disclosure required by paragraph 29.32(a), (d) and (e)

It is assumed that under 29.32(a) there is no current tax relating to items that are recognised as items of other comprehensive income.

Ex 112 **An entity could disclose income tax expense as follows:**

[Extract from] Note X Deferred tax

The following are the deferred tax liabilities (assets) recognised by the Group:

	Software	*Other long-term employee benefit*	*Foreign exchange loss on net investment*	*Unused tax credits*	*Total*
	CU	*CU*	*CU*	*CU*	*CU*
1 January 20X1	170	(500)	20	–	(310)
Charge (credit) to profit or loss for the year	(68)	(17)	–	–	(85)
Charge (credit) to other comprehensive income for the year	–	–	(40)	–	(40)
1 January 20X2	102	(517)	(20)	–	(435)
Charge (credit) to profit or loss for the year	(68)	(31)	–	(200)	(299)
Charge (credit) to other comprehensive income for the year	–	–	10	–	10
31 December 20X2	34	(548)	(10)	(200)	(724)

The tax credits were provided to the entity for operating in a designated development zone and can only be set off against tax relating to income tax payable on profits from that particular zone. The deferred tax asset for the unused tax credits is shown net of a valuation allowance of CU100. The total deferred tax asset for unused tax credits on 31 December 20X2 is CU300 (31 December 20X1: CU0). A valuation allowance of CU100 is recognised against the deferred tax asset on 31 December 20X2 to reduce the carrying amount to the highest amount that is more likely than not to be recovered based on future profits from the designated operating zone. Any unused tax credits will expire on 31 December 20X6.

Example – disclosure required by paragraph 29.32(b)

Ex 113 **An entity could disclose income tax expense as follows:**

[Extract from] Note 10 Deferred tax

Income tax is calculated at 40 per cent in 20X2 (20X1: 40 per cent) of the estimated assessable profit for the year.

Income tax expense for the year, CU230 in 20X2 (CU197 in 20X1), differs from the amount that would result from applying the tax rate of 40 per cent (both 20X2 and 20X1) to profit before tax because, under the tax laws of [name of the entity's tax jurisdiction], some employee compensation expenses (CU31 in 20X2 and CU45 in 20X1) that are recognised in measuring profit before tax are not tax-deductible.

Example – illustration of paragraph 29.32(c) if there is a change in tax rates

Ex 114 **An entity could disclose income tax expense as follows:**

[Extract from] Note 10 Deferred tax

A change in the income tax rate from 20 per cent to 22 per cent was enacted on 1 July 20X2, effective from 1 January 20X3. Deferred tax assets and liabilities on temporary differences that are expected to reverse after 1 January 20X3 are measured at 22 per cent.

Example – illustration of paragraph 29.32(f)

Ex 115 **An entity could disclose income tax expense as follows:**

[Extract from] Note 10 Deferred tax

An entity operates in a jurisdiction where income taxes are payable at a higher rate on undistributed profits (50 per cent) with an amount being refundable when profits are distributed. The tax rate on distributed profits is 35 per cent. At 31 December 20X2, the entity did not recognise a liability for dividends payable because dividends for the year were declared after the year end. Consequently, the entity recognised current tax expense based on the higher rate of 50 per cent. In 20X3 when the entity declares the dividend of CU10,000, the entity becomes entitled to the recovery of CU1,500 of current tax. This will be recognised as a current tax asset on the date the dividends are declared and a corresponding reduction in the current tax expense will be recognised in 20X3.

SIGNIFICANT ESTIMATES AND OTHER JUDGEMENTS

Applying the requirements of the *IFRS for SMEs* to transactions and events often requires judgement. Information about significant judgements and key sources of estimation uncertainty is useful in assessing the financial position, performance and cash flows of an entity. Consequently, in accordance with paragraph 8.6, an entity must disclose the judgements that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements. Furthermore, in accordance with paragraph 8.7, an entity must disclose information about the key assumptions concerning the future, and other key sources of estimation uncertainty at the reporting date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

Other sections of the *IFRS for SMEs* require disclosure of information about particular judgements and estimation uncertainties. Some of the judgements in accounting for income tax are set out below.

Scope

The determination of whether or not a tax is an 'income tax' sometime requires judgment, based on the specific facts and circumstances (eg the nature of the tax and how it is determined).

Examples

In entity A's jurisdiction, tax is assessable by reference to an amount that is calculated as an entity's revenue less certain specified costs. In entity B's jurisdiction tax is assessable by reference to an amount equal to 20 per cent of an entity's revenue.

Although assessing tax on either 'revenue less certain specified costs' or 'a percentage of revenue' is not equivalent to assessing tax on income less expenses, to the extent that the amounts are determined as a surrogate for taxable income (eg the percentage applied to revenue is determined based on historical net margins and is set to approximate taxable income), it may imply that the tax is an income tax in nature and thus should be accounted for under Section 29. Judgement needs to be applied based on a careful consideration of all the facts.

An entity is required to pay tax which is calculated as the sum of two components, an amount based on the volume of products sold and an amount based on profits. The amount based on profits is only payable if the volume of products sold is over a certain minimum level.

The amount of tax based on the volume of products sold would not be within the scope of Section 29 because it is not based on taxable profits. On the other hand, any additional amounts due as a result of the profit-based component would be considered to be income tax within the scope of Section 29.

Recognition

Paragraph 29.16(a) exempts an entity from recognising deferred taxes for permanently reinvested unremitted earnings of foreign subsidiaries, foreign associates or foreign joint

ventures that are essentially permanent in nature. In some cases significant judgement is required to determine whether an investment in a foreign subsidiary, foreign associate or foreign joint venture is essentially permanent in nature. The following are examples of some of the factors that would be considered in making the assessment:

- any specific plans made for reinvestment such as to grow the investee;
- past dividend payments made by the investee;
- any agreements in place that would require a dividend payment to be made or established policies for paying dividends; and
- whether any legal requirements exist that would force the investee to pay distributions.

If circumstances change and it becomes apparent that all or part of an investment in a foreign subsidiary, foreign associate or joint venture is no longer essentially permanent in duration, the entity shall recognise the related deferred tax asset or liability. Conversely, if it becomes apparent that all or part of an investment in a foreign subsidiary, foreign associate or joint venture has become essentially permanent in duration, the entity shall derecognise any related deferred tax asset or liability. For example, when an entity loses control of a foreign subsidiary that was essentially permanent in duration this may mean that the entity can no longer make plans to reinvest dividends. In this case, for any remaining investment, the entity recognises a deferred tax asset or liability for the temporary difference between the carrying amount of the investment and its tax basis (unless the exception in paragraph 29.16(a) applies). The resulting deferred tax expense is recognised in profit or loss.

Measurement

Graduated tax rates

When different tax rates apply to different levels of taxable profit, an entity may need to apply judgement in estimating the average rates that will be applicable when it expects the deferred tax asset to be realised or deferred tax liability to be settled. For example, an entity may need to estimate taxable profits in a future year to determine the tax rate that will apply in that year.

Substantive enactment

In some jurisdictions particular actions by the government relating to tax rates and tax laws have the substantive effect of actual enactment, even though official enactment may not have taken place. In such cases, judgement will need to be applied in determining whether or not the actions by the government mean a change in tax rates or tax laws has been substantively enacted. Normally whether or not substantive enactment constitutes actual enactment will be decided for all entities within a single tax jurisdiction for consistency (ie it would generally be determined by a consensus of the accounting profession, rather than by each entity individually).

Uncertain tax positions

Judgement needs to be applied when there is uncertainty over the treatment of amounts which are reported on the tax return, for example if an entity is unsure whether a particular expense meets the requirements to be tax-deductible. Where management has doubt over the appropriate tax treatment, the entity must include this in the measurement of current and deferred tax, unless it is immaterial. The assessment of the different outcomes and associated

probabilities required when there is such an uncertainty may be quite a subjective process.

Valuation allowance

In accordance with paragraph 29.21 an entity recognises a valuation allowance against deferred tax assets so that the net carrying amount equals the highest amount that is more likely than not to be recovered based on current or future taxable profit. The extent of analysis (eg forecasts or projections) necessary to support not recognising a valuation allowance against a deferred asset is a matter of judgment. The greater the doubt over whether the deferred tax asset can be realised in full, the more significant the analysis should generally be. For example, more analysis would be necessary if an entity has incurred losses in the current and preceding periods and the recovery of the deferred tax asset is dependent upon future taxable profits in excess of those arising from the reversals of existing taxable temporary differences. The following sources of taxable profit may be available to realise a tax benefit for temporary differences and unused tax losses and tax credits:

(a) Future reversals of existing temporary differences that will result in future taxable amounts (ie increase taxable profit) relating to the same taxation authority and the same taxable entity:

(i) in the same period as the expected reduction in the temporary difference giving rise to the tax benefit; or

(ii) in periods into which a tax loss arising from the reduction in (a)(i) can be carried back or forward.

However, in determining the existence of taxable profit available to realise a tax benefit, an entity shall not consider reductions in temporary differences for which, in accordance with paragraph 29.16(a), no deferred tax liability has been recognised.

(b) Future taxable profit (exclusive of future reductions in existing temporary differences) relating to the same taxation authority and the same taxable entity:

(i) in the same period as the expected reduction in a temporary difference giving rise to the tax benefit; or

(ii) in periods into which a tax loss arising from the reduction in (b)(i) can be carried back or forward.

In evaluating whether it will have sufficient taxable profit in future periods to realise a tax benefit, an entity shall ignore taxable amounts expected to originate in future periods that will themselves give rise to temporary differences.

(c) Tax planning strategies that would create taxable profit in appropriate periods.

Future reversals of existing taxable temporary differences can be objectively verified. Future taxable profit (exclusive of future reductions in existing temporary differences and tax-planning strategies represent future events and, therefore, are more subjective. Hence (a) should be considered first and, to the extent that those sources will generate sufficient taxable income of the right character in the appropriate timeframe, there is no need to evaluate the likelihood of other future taxable income.

Tax planning strategies are actions (including elections for tax purposes) that:

(i) are feasible and rational,

(ii) an entity would take in order to create or increase taxable profit in a particular period before the expiry of a tax loss or tax credit carryforward, and

(iii) would result in the realisation of deferred tax assets.

For example, in some jurisdictions, taxable profit may be created or increased by:

- accelerating taxable amounts to use expiring carryforwards (eg electing to have interest income taxed on either a received or receivable basis; selling, and perhaps leasing back, assets that have appreciated but for which the tax basis has not been adjusted to reflect such appreciation)
- deferring the claim for some deductions from taxable profit
- changing the character of taxable or deductible amounts (eg from being taxable as part of profit to being taxable as a capital gain or loss)
- switching from tax-exempt to taxable investments (eg selling an asset that generates non-taxable profit in order to purchase another investment that generates taxable profit).

Evidence available for the sources of taxable profit

Evidence available about each of the possible sources of taxable profit noted above will vary for different tax jurisdictions and, possibly, from period to period. If evidence about one or more sources of taxable profit is sufficient to support a conclusion that it is more likely than not that taxable profit will be available to use temporary differences and unused tax losses and tax credits, an entity need not consider other sources. However, consideration of each source is required to determine the amount of the valuation allowance to be recognised.

An entity shall consider all available evidence, both positive and negative, to determine whether, on the basis of the weight of that evidence, it is more likely than not that taxable profits will be available.

Ordinarily, information about an entity's present financial position and its results of operations for the current and preceding years is readily available. That historical information is supplemented by all currently available information about future years. Sometimes, however, historical information may not be available (eg start-up operations) or it may not be as relevant (eg if there has been a recent change in circumstances) in which case other evidence is required to support a conclusion that it is more likely than not that taxable profits will be available for the entity to use temporary differences and unused tax losses and credits.

The existence of unused tax losses or tax credits is strong evidence that future taxable profit may not be available. The same would apply if there were a history of losses in recent years and a history of unused tax losses or tax credits expiring unused. Other examples of negative evidence include, but are not limited to, the following:

(a) losses expected in early future years by a currently profitable entity

(b) uncertain circumstances that, if unfavourably resolved, would adversely affect future operations and profit on a continuing basis. For example if the entity discovers it has sold faulty products to customers and it is concerned that once this is discovered it will affect sales in the future.

(c) a carryback or carryforward period that is so brief that it would limit realisation of tax benefits if a significant temporary difference is expected to reduce to zero in a single year or the entity operates in a traditionally cyclical business.

Consequently, when an entity has a history of recent losses or there is other negative evidence, it shall recognise a valuation allowance against the deferred tax asset arising from unused tax losses or tax credits. This allowance is set at an amount such that the net amount equals the amount for which it has sufficient temporary differences to give rise to taxable profit in the future, or for which there is convincing other evidence that sufficient taxable profit will be

available.

Examples of other evidence that might support a conclusion that a valuation allowance is not needed despite negative evidence include, but are not limited to, the following:

(a) existing contracts or firm sales backlog that will produce more than enough taxable income to realise the deferred tax asset on the basis of existing sales prices and cost structures. For example, a five-year contract with lucrative terms.

(b) an excess of unrecognised asset value over the tax basis of the entity's net assets sufficient to realise the deferred tax asset.

(c) a strong earnings history exclusive of any loss that created the deferred tax asset, coupled with evidence indicating that the loss results from identifiable causes that are unlikely to recur. For example, the loss may relate to a natural disaster such as flooding.

An entity shall use judgement in considering the relative effect of negative and positive evidence. The weight given to the potential effect of negative and positive evidence shall be commensurate with the extent to which it can be objectively verified. The more negative evidence that exists, the more positive evidence is necessary, and the more difficult it is to conclude that the valuation allowance should be less than the full amount of the deferred tax asset.

COMPARISON WITH FULL IFRSs

There are a number of differences between the requirements for accounting for income tax in accordance with full IFRSs (see IAS 12 *Income Taxes*) and in Section 29. There are two main reasons for this. Firstly, the *IFRS for SMEs* is drafted in simple language with less application guidance than is provided in full IFRSs, and secondly Section 29 follows much of the approach set out in the IASB's exposure draft ED/2009/2 *Income Tax*, published in March 2009, which proposes a replacement for IAS 12.

Main differences between IFRS for SMEs *and ED/2009/2*

The main measurement difference in the *IFRS for SMEs* as compared with ED/2009/2 is where a different tax rate applies to distributed and undistributed income. The *IFRS for SMEs* requires current and deferred taxes to be measured initially at the rate applicable to undistributed profits, with adjustment in subsequent periods if the profits are distributed. ED/2009/2 would initially measure current and deferred taxes at the tax rate expected to apply when the profits are distributed.

Three other differences between ED/2009/2 and Section 29 are:

- Section 29 is drafted in a simple language with less application guidance.
- ED/2009/2 requires the current/non-current classification of deferred tax assets and liabilities to mirror the related asset or liability. The *IFRS for SMEs* requires all deferred tax assets and liabilities to be classified as non-current.
- On the initial measurement of assets and liabilities that have tax bases different from their initial carrying amounts. ED/2009/2 introduces proposals to disaggregate such assets and liabilities into (i) an asset or liability excluding entity-specific tax effects and (ii) any entity-specific tax advantage or disadvantage (a type of split accounting). Section 29 is silent on the initial measurement of assets and liabilities that have tax bases different from their initial carrying amounts.

Main differences between IFRS for SMEs *and IAS 12*

The key differences between full IFRSs (IAS 12 as issued at 9 July 2009) and Section 29 are:

- Section 29 is drafted in a simple language with less application guidance.
- A different definition of tax basis.
- Section 29 requires the tax basis of an asset to be determined by the tax deductions that would be available if the entity recovered the carrying amount of the asset by sale. IAS 12 requires the tax basis to be determined depending upon how the entity expects to recover the carrying amount of an asset. However, the *IFRS for SMEs* still considers expectations of how the asset will be used in accounting for deferred tax (see next bullet point).
- Section 29 includes an initial step in determining deferred tax assets and liabilities—no deferred tax arises in respect of an asset or liability if there is not expected to be an effect on taxable profit when the entity recovers or settles its carrying amount. This step considers the expected manner of recovery of the asset/settlement of the liability. IAS 12 does not contain this initial step in accounting for deferred tax.
- Section 29 does not have the initial recognition exception that is contained in IAS 12.

The initial recognition exception prohibits an entity from recognising deferred tax assets and liabilities that arise when an asset or liability has a tax basis different from its initial carrying amount, except in a business combination or in a transaction affecting accounting or taxable profit. Section 29 is silent on this point.

- Section 29 and IAS 12 contain different exceptions from the temporary difference approach relating to a deferred tax asset or liability arising from investments in subsidiaries, branches, associates and joint ventures. The *IFRS for SMEs* restricts the exception to investments in foreign subsidiaries, associates, joint ventures or branches that are essentially permanent in duration. IAS 12 restricts the exception to where the investor 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.
- Under Section 29 deferred tax assets are recognised in full, less, if applicable, a valuation allowance to reduce the net carrying amount to the highest amount that is more likely than not to be realisable against taxable profit. IAS 12 has a single-step recognition requirement for the portion of a deferred tax asset for which realisation is probable.
- Under Section 29 current and deferred tax assets and liabilities are measured using the probability-weighted average amounts of possible outcomes assuming that the tax authorities will examine the amounts reported to them by the entity and will have full knowledge of all relevant information. IAS 12 is silent on the treatment of such uncertainty over tax amounts.

Section 29 contains additional clarification that 'substantively enacted' means that future events required by the enactment process historically have not affected the outcome and are unlikely to do so.

TEST YOUR KNOWLEDGE

Test your knowledge of the requirements for accounting and reporting income tax in accordance with the *IFRS for SMEs* by answering the questions below.

Once you have completed the test check your answers against those set out below this test.

Assume that all amounts are material.

Mark the box next to the most correct statement.

Question 1

Income tax consists of:

☐ (a) domestic taxes that are based on taxable profits.

☐ (b) foreign taxes that are based on taxable profits.

☐ (c) taxes that are payable by a subsidiary, associate or joint venture on distributions to the reporting entity.

☐ (d) all of the above.

Question 2

An entity determines its taxable profit for the year ended 30 April 20X8 to be CU200,000. The tax rate for 20X8 is 40 per cent. Which of the following journal entries is appropriate to record the current tax for the year?

☐ (a) Debit Current tax asset CU80,000;
Credit Current tax income CU80,000.

☐ (b) Debit Current tax asset CU200,000;
Credit Current tax income CU200,000.

☐ (c) Debit Current tax expense CU80,000;
Credit Current tax liability CU80,000.

☐ (d) Debit Current tax expense CU200,000;
Credit Current tax liability CU200,000.

Question 3

An entity makes a taxable loss for the year ended 30 April 20X8 of CU30,000. For the year ended 30 April 20X7 the entity had taxable profits of CU20,000. In the entity's jurisdiction, tax losses are allowed to be carried back to the prior year only. The tax rate is 40 per cent for both the tax year 20X7/20X8 and the tax year 20X6/20X7. What journal entry should the entity make on 30 April 20X8 for the tax loss carryback?

☐ (a) Debit Current tax asset CU8,000;
Credit Current tax income CU8,000.

☐ (b) Debit Current tax asset CU12,000;
Credit Current tax income CU12,000.

☐ (c) Debit Current tax expense CU8,000;
Credit Current tax liability CU8,000.

☐ (d) Debit Current tax expense CU12,000;
Credit Current tax liability CU12,000.

Question 4

(i) to (iv) list the first four steps in accounting for deferred tax (the first four steps of the deferred tax methodology). What is their correct order?

(i) Compute any temporary differences, unused tax losses and unused tax credits.

(ii) Determine the tax basis at the reporting date of all those assets and liabilities, and of other items that have a tax basis.

(iii) Recognise deferred tax assets and liabilities arising from the temporary differences, unused tax losses and unused tax credits.

(iv) Identify which assets and liabilities are expected to affect taxable profit if they were recovered or settled for their carrying amount.

☐ (a) (i), (ii), (iii), (iv).

☐ (b) (iv), (ii), (i), (iii).

☐ (c) (ii), (iv), (i), (iii).

☐ (d) (ii), (i), (iii), (iv).

Question 5

The tax basis is the measurement, under applicable substantively enacted tax law, of an asset, liability or equity instrument. If the recovery of the asset through sale will increase taxable profit, the asset's tax basis is equal to which of the following?

☐ (a) The amount that would have been deductible in arriving at taxable profit if the carrying amount of the asset had been recovered through use at the end of the reporting period.

☐ (b) The amount that would have been deductible in arriving at taxable profit if the carrying amount of the asset had been recovered through sale at the end of the reporting period.

☐ (c) The amount that would have been deductible in arriving at taxable profit if the carrying amount of the asset had been recovered through the expected manner of recovery (ie either use or sale, or a combination of use or sale) at the end of the reporting period.

☐ (d) Nil

Question 6

On 31 December 20X1, an entity has an asset of CU4,000 for interest receivable that will be taxed when the cash is received in 20X2. Tax is payable at 20 per cent on the first CU500,000 of taxable profit earned and 30 per cent on any remainder (ie excess above CU500,000). In 20X1 the entity earned taxable profit of CU450,000. In 20X2 the entity expects to earn taxable profit of CU550,000. What amount should the entity recognise for the deferred tax liability relating to the interest receivable?

☐ (a) Deferred tax liability of CU1,200.

☐ (b) Deferred tax liability of CU1,000.

☐ (c) Deferred tax liability of CU940.

☐ (d) Deferred tax liability of CU836.

☐ (e) Deferred tax liability of CU800.

Question 7

Which of the following items should not be recognised by an entity?

☐ (a) A deferred tax asset or liability for temporary differences associated with unremitted earnings from foreign subsidiaries, branches, associates and joint ventures to the extent that the investment is essentially permanent in duration, unless it is apparent that the temporary difference will reverse in the foreseeable future.

☐ (b) A deferred tax liability for a temporary difference associated with the initial recognition of goodwill.

☐ (c) Both (a) and (b).

Question 8

In 20X1 an entity reports taxable profit of CU50,000 to the tax authority, which will be taxed at the corporate income tax rate in the jurisdiction of 30 per cent. The capital gains rate is nil and so capital gains are excluded from taxable profit. The management of the entity considers the effect of uncertainty over the amounts reported in the tax return to be immaterial except in relation to the treatment of the profit on the sale of a particular asset. In relation to that asset, management have determined that there is an 80 per cent probability that the gain of CU5,000 is a capital gain and therefore will not be taxed, and that there is a 20 per cent probability that the gain of CU5,000 is not a capital gain and therefore will be taxed at 30 per cent.

How should the entity measure its current tax liability based on the taxable profit?

☐ (a) CU16,500.

☐ (b) CU16,200.

☐ (c) CU15,300.

☐ (d) CU15,000.

Question 9

What is the correct treatment regarding discounting of income tax assets and liabilities?

☐ (a) Current tax assets and liabilities are discounted. Deferred tax assets and liabilities are not discounted.

☐ (b) Current tax assets and liabilities are not discounted. Deferred tax assets and liabilities are discounted.

☐ (c) Current and deferred tax assets and liabilities are discounted.

☐ (d) Current and deferred tax assets and liabilities are not discounted.

Question 10

An entity operates in a jurisdiction where income taxes are payable at a lower rate on undistributed profits (20 per cent) with an additional amount (10 per cent) being payable when profits are distributed (ie the tax rate on distributed profits is 30 per cent). On 31 December 20X1 the entity expects to propose dividends in March 20X2 of approximately CU20,000 for the year ended 20X1. The financial statements will be authorised for issue in April 20X2. Taxable profit for 20X1 is CU100,000. The entity has temporary differences that are expected to increase taxable profit in the future for the year 20X1 of CU30,000. The entity was formed on 1 January 20X1. On 31 December 20X1 the entity should recognise the following:

☐ (a) A current tax liability (and expense) of CU20,000 and a deferred tax liability (and expense) of CU6,000.

☐ (b) A current tax liability (and expense) of CU20,000 and a deferred tax liability (and expense) of CU9,000.

☐ (c) A current tax liability (and expense) of CU22,000 and a deferred tax liability (and expense) of CU6,000.

☐ (d) A current tax liability (and expense) of CU25,000 and a deferred tax liability (and expense) of CU7,500.

☐ (e) A current tax liability (and expense) of CU30,000 and a deferred tax liability (and expense) of CU9,000.

Answers

Q1 (d) see paragraph 29.1
Q2 (c) see paragraph 29.4—CU200,000 × 40%
Q3 (a) see paragraph 29.5—CU20,000 × 40%
Q4 (b) see paragraph 29.10–29.15
Q5 (b) see paragraph 29.12
Q6 (d) see paragraph 29.19
= ((CU500,000 × 20%) + (CU50,000 × 30%)) ÷ CU550,000 = CU115,000 ÷ CU550,000 = 20.91 per cent.
CU4,000 × 20.91% = CU836
Q7 (c) see paragraph 29.16
Q8 (c) see paragraph 23.20—(CU50,000 × 30%) + (0 × 80%) + (CU5,000 × 30% × 20%)
Q9 (d) see paragraph 29.23
Q10 (a) see paragraph 29.25—(CU100,000 × 20%) + (CU30,000 × 20%)

APPLY YOUR KNOWLEDGE

Apply your knowledge of the requirements for accounting and reporting income tax in accordance with the *IFRS for SMEs* by solving the case studies below.

Once you have completed the case studies check your answers against those set out at the end of this test.

Case study 1

SME A has a financial year end of 31 March. The tax year in SME A's tax jurisdiction runs from 1 April to 31 March. The tax law permits entities to carry tax losses back two years and set them off against any taxable profits of those prior years. Tax law also permits any tax losses that cannot be carried back to be carried forward ten years. The income tax liability due for the year ended 31 March is payable by 15 December of the same year.

In the year ended 31 March 20X0, SME A made a tax loss of CU80,000 because of an unexpected localised flood and the unanticipated closure of a major supplier. These two events are considered one-off events and at the time SME A was expected to return to profitability and remain profitable for the foreseeable future. Of that tax loss, CU9,000 remains unused on 1 April 20X0 which cannot be carried back to the years ended 31 March 20W8 and 20W9.

In SME A's tax jurisdiction the standard income tax rate of 30 per cent has applied for many years. On 1 November 20X0 the tax authority announced a change in tax rate from 30 per cent to 32 per cent which will take effect on 1 April 20X1. The announcement on 1 November 20X0 is considered substantive enactment.

For the year ended 31 March 20X1, SME A recognised total comprehensive income of CU170,000 and profits are expected to grow in the near future.

In the year ended 31 March 20X0 and 20X1 the rules for determining taxable profit are identical to determining profits for financial reporting purposes under the *IFRS for SMEs* except in respect of the five transactions/items described separately below. Also assume that, other than for these five items below, there are no assets, liabilities or other items that will affect the recognition and measurement of deferred tax.

Machinery

On 31 March 20X1, SME A has machinery costing CU500,000 that was purchased on 1 April 20W9 and is measured at depreciated cost. The cost of the machine is deductible from taxable income either as the machine is used (via tax depreciation) or, alternatively, on sale. Tax depreciation is applied on a straight-line basis over five years. For financial reporting purposes, the machinery is being depreciated on a straight-line basis over ten years to its residual value of nil. Income generated by using the machine is taxable, and any gain or loss on disposal of the machine will be taxable or deductible for tax purposes through a balancing adjustment (such as clawback of capital allowances claimed). At 31 March 20X1 CU200,000 of tax depreciation has been deducted in the years ended 31 March 20X0 and 31 March 20X1 and

the remaining cost will be deductible in future periods either as depreciation or through a deduction on disposal.

Research costs

Research costs of CU4,000 are recognised as an expense in determining accounting profit for 20X1, but are permitted as a deduction in determining taxable profit in the next two years (ie CU2,000 in 20X2 and CU2,000 in 20X3). No research costs were charged in previous years.

Employee benefits

On 31 March 20X1, SME A has a liability for an amount due to employees of CU50,000 relating to services already rendered by the employees to the entity. It is due to be paid in April 20X1. The expense is tax-deductible when paid. On 31 March 20X0 there was a similar liability for CU60,000 which was paid in April 20X0 (ie the CU60,000 is tax-deductible in the year ended 31 March 20X1 (but is expensed in 20X0 for financial reporting purposes) and the CU50,000 is tax-deductible in the year ended 31 March 20X2 (but expensed in 20X1 for financial reporting purposes) – giving an additional decrease in taxable profit over accounting profit for the year ended 31 March 20X1 of CU10,000).

Trade receivable

On 31 March 20X1, SME A has gross trade receivables of CU300,000 with an allowance for bad or doubtful debts set against it for CU20,000. An allowance for bad or doubtful debts is only tax-deductible when the debt is six months overdue and formally written off. On 31 March 20X0 the entity had gross trade receivables of CU250,000 with an allowance for bad or doubtful debts set against it for CU15,000. No bad debts were written off for tax purposes in the year.

Fine

On 15 January 20X1 SME A paid a fine of CU30,000 for accidental pollution of a nearby lake. This amount is recognised as an expense from accounting profit for 20X1. On the basis of advice received from a reputable tax lawyer, the entity believes that the tax law is unclear about whether the fine is tax deductible. However, the entity has deducted the CU30,000 in its tax return for the year ended March 20X1 and has made appropriate disclosures about the deduction so that the tax authorities can appropriately assess its deductibility. The entity estimates that the probability of the tax authority allowing the deduction is 25 per cent (ie the entity estimates that there is a 75 per cent probability that the deduction will not be accepted).

Part A
Prepare journal entries to record the current tax expense and deferred tax expense for the year ended 31 March 20X1.

Part B
Assume that the financial statements are authorised for issue on 30 June 20X1 and that the tax authorities inform the entity that it is not permitted to deduct the fine from taxable profit on 30 August 20X1, and the entity pays the amount outstanding on 15 December 20X1.

Prepare journal entries to record the current tax payment.

Part C
Prepare extracts from the financial statements for the year ended 31 March 20X1 showing how to present and disclose income tax (eg extracts from the statement of income and retained earnings, statement of financial position and accounting policy note, and also notes satisfying the disclosure requirements in Section 29).

Ignore the statement of cash flows.

Some of the comparatives will not be determinable. If this is the case, mark 'X' in place of the number.

Answer to case study 1

Part A

Year ended 31 March 20X1

Current tax

Dr	Income tax – current tax (profit or loss)	CU39,750[(a)]	
	Cr Current tax liability		CU39,750

To recognise the current tax expense for the year ended 31 March 20X1 in profit or loss assuming that no expense relates to items outside profit or loss (ie in other comprehensive income or equity).

Deferred tax

Dr	Income tax – deferred tax (profit or loss)	CU18,520[(b)]	
	Cr Deferred tax asset		CU1,520[(b)]
	Cr Deferred tax liability		CU17,000[(b)]

To recognise the change in the deferred tax assets and liabilities between 1 April 20X0 and 31 March 20X1 (ie the deferred tax expense for the year ended 31 March 20X1) in profit or loss.

Part B

Year ended 31 March 20X2

Current tax determined on 30 August 20X1

Dr	Income tax – current tax (profit or loss)	CU2,250[(a)]	
	Cr Current tax liability		CU2,250

To recognise the adjustment to the current tax expense for the year ended 31 March 20X1 in profit or loss in the year ended 31 March 20X2.

Notes:

On the date that the tax authorities confirm the amount due (ie 30 August 20X1), the financial statements for 31 March 20X1 had already been authorised for issue, so this is not an adjusting event in the financial statements for the year ended 31 March 20X1. In this case there does not seem to be a prior period error in the accounting for taxes in the 31 March 20X2 financial statements, but instead a change in accounting estimate (see Section 10 *Accounting Policies, Estimates and Errors*). Consequently, the adjustment is made in the statement of comprehensive income for the year ended 31 March 20X2.

The CU2,250 is disclosed in accordance with paragraph 29.31(b) in the note disclosures for the year ended 31 March 20X1.

Note: if the adjustment had been made in respect of a prior period error (eg a deliberate misstatement in the prior period's financial statements due to tax fraud) then the adjustment would be a correction of the prior period error that would be accounted for by retrospectively restating the prior period financial information.

Current tax paid on 15 December 20X1

Dr	Current tax liability	CU42,000[a]	
	Cr Cash		CU42,000

Part C

SME A

[Extract from] Consolidated statement of income and retained earnings for the year ended 31 March 20X1

	Note	*Year ended 31 March 20X1 CU*	*Year ended 31 March 20X0 CU*
Revenue		X	X
Cost of sales		X	X
Gross profit		X	X
Other income		X	X
Distribution costs		X	X
Administrative expenses		X	X
Other expenses		X	X
Finance costs		X	X
Profit before tax		X	X
Income tax expense	10	58,270 [b]	X
Profit after tax		X	X
Retained earnings at the start of the year		X	X
Dividends		X	X
Retained earnings at the end of the year		X	X

SME A

[Extract from] Consolidated statement of financial position at 31 March 20X1

	31 March 20X1 CU	*31 March 20X0 CU*
ASSETS		
Current assets		
Cash	X	X
Current tax asset	–	21,300 [d]
Trade and other receivables	X	X
Inventories	X	X
	X	X
Non-current assets		
Property, plant and equipment	X	X
Intangible assets	X	X
Deferred tax asset	–	10,200 [c]
	X	X
Total assets	X	X

LIABILITIES AND EQUITY		
Current liabilities		
Bank overdraft	X	X
Trade payables	X	X
Interest payable	X	X
Current tax liability	39,750 (a)	–
Non-current liabilities		
Bank loan	X	X
Deferred tax liability	8,320 (e)	–
Total liabilities	X	X
Equity		
Share capital	X	X
Retained earnings	X	X
	X	X
Total liabilities and equity	X	X

SME A

[Extract from] Notes

Note 2 Accounting policies

Income tax

Income tax expense represents the sum of current tax payable and deferred tax.

Current tax

Current tax payable for the year is based on taxable profit for the year. Taxable profit differs from profit as reported in the consolidated statement of comprehensive income, because of items of income or expense that are taxable or deductible in different years, and items that are never taxable or deductible. The current tax liability is calculated using tax rates that have been enacted or substantively enacted by the end of the reporting period. A formal government announcement of changes in tax rates or tax laws is considered substantive enactment in the jurisdiction.

The tax law permits entities to carry tax losses back one year and to set them off against profits of that prior year. Tax law also permits any tax losses that cannot be carried back to be carried forward ten years.

Deferred tax

Deferred tax is accounted for using a temporary difference approach. A deferred tax liability is recognised for all temporary differences that are expected to increase taxable profit in the future. Deferred tax assets are recognised for all temporary differences that are expected to reduce taxable profit in the future, and the carryforward of unused tax losses and unused tax credits. Temporary differences are differences between the carrying amount of an asset, liability or other item in the financial statements and its tax basis that are expected to affect taxable profit when the carrying amount of the asset or liability is recovered or settled (or, in the case of items other than assets and liabilities, that will affect taxable profit in the future.

A valuation allowance is recognised against deferred tax assets so that the net amount equals the highest amount that is more likely than not to be realised on the basis of current or future taxable profit. The net carrying amount of deferred tax assets is reviewed at each reporting date and is adjusted to reflect the current assessment of future taxable profits.

Deferred tax is calculated at the tax rates that are expected to apply to the taxable profit (tax loss) of the

periods in which it expects the deferred tax asset to be realised or the deferred tax liability to be settled, on the basis of tax rates that have been enacted or substantively enacted by the end of the reporting period.

An entity recognises tax expense in either profit or loss, other comprehensive income or equity depending on the transaction or other event that resulted in the tax expense.

SME A

[Extract from] Note 10 Income tax expense

	Year ended 31 March 20X1 CU	*Year ended 31 March 20X0 CU*
Tax expense comprises:		
Current tax expense	39,750	–
Adjustments recognised in period for current tax of prior periods	–	–
Amount of deferred tax expense relating to the origination and reversal of temporary differences	18,000[(f)]	X
Amount of deferred tax expense (income) relating to changes in tax rates	520[(f)]	–
Total tax expense	58,270	X

The following deferred tax liabilities (assets) are recognised by the Group[(c) & (e)].

	Machinery	*Research and development costs*	*Employee Benefits*	*Trade receivables*	*Unused tax losses*	*Total*
	CU	*CU*	*CU*	*CU*		*CU*
1 April 20W9	–	–	X	X	–	X
Charge (credit) to profit or loss for the year	15,000	–	X	X	–	X
31 March 20X0	15,000	–	(18,000)	(4,500)	(2,700)	(10,200)
Charge (credit) to profit or loss for the year	17,000	(1,280)	2,000	(1,900)	2,700	18,520
31 March 20X1	32,000	(1,280)	(16,000)	(6,400)	–	8,320

None of the deferred tax assets for the research and development costs, employee benefits and trade receivables have a valuation allowance set against them because all are expected to be fully realisable based on future taxable profits.

The income tax expense for the year of CU58,270 in 20X1 (CUX in 20X0) differs from the amount that would result from applying the tax rate of 30 per cent (in both 20X1 and 20X0) to total comprehensive income because, under the tax laws of [name of the SME A's tax jurisdiction], some expenses that are deducted in measuring accounting profit are tax deductible in a different reporting period.

Current tax is calculated at 30 per cent in 20X1 (20X0: 30 per cent) of the estimated assessable profit for the year. A change in the income tax rate from 30 per cent to 32 per cent was substantively enacted on 1 November 20X0, effective from 1 April 20X1. Deferred tax assets and liabilities on temporary differences that are expected to reverse after 1 April 20X1 are measured at 32 per cent (20X0: 30%).

The calculations and explanatory notes below do not form part of the answer to this case study:

(a) Current tax payable on taxable profit may be determined as follows:

	CU
Total comprehensive income for the year ended 31 March 20X1	170,000
Less additional depreciation deductible (CU100,000 less CU50,000)	(50,000)
Plus research expenses not tax deductible until 20X2 and 20X3	4,000
Plus increase in bad debt allowance not deductible (CU20,000 less CU15,000)	5,000
Less additional employee benefits tax deductible in 20X1 (CU60,000 less CU50,000)	(10,000)
Taxable profit before consideration of unused tax losses	119,000
Tax loss carried forward	(9,000)
Taxable profit reported to the tax authorities	110,000
Adjustment for the uncertain tax position (CU30,000 fine expense × 75% probability that the deduction will be disallowed by the tax authorities)	22,500
Adjusted taxable income	132,500
Current tax expense (30% × CU132,500 adjusted taxable income)	39,750

If the fine is not deductible the entity will need to pay CU42,000 (ie CU140,000 × 30%).

The adjustment to the current tax expense for the year ended 31 March 20X1 in profit or loss in the year ended 31 March 20X2 is CU2,250 (ie CU42,000 less CU39,750).

A reconciliation between taxable profit and accounting profit is used in this case study in order to determine taxable profit. However, this reconciliation is not required by the *IFRS for SMEs*. Other methods of determining taxable profit and current tax expense are equally appropriate, such as determining taxable profit separately from accounting profit. A reconciliation is usually the simplest method where tax rules are similar to accounting under the *IFRS for SMEs* (ie differ only in a few instances).

(b) The movement in the net deferred tax asset for the year is an expense of CU18,520 (ie CU10,200[(c)] + CU8,320[(e)]). This is comprised of an increase in the deferred tax liability of CU17,000 (ie CU32,000[(e)] less CU15,000[(c)]) and a decrease in the deferred tax asset of CU1,520 (ie CU25,200[(c)] less CU23,680[(e)]). Hence the total income tax expense for the year ended 31 March 20X1 is CU58,270 (ie CU18,520 deferred tax + CU39,750[(a)] current tax).

(c) Deferred tax assets and liabilities on 31 March 20X0:

Item - Recovery or settlement of carrying amount expected to affect taxable profit	*Carrying amount*	*Tax basis*	*Temporary difference*	*Deferred tax @30%*
Machinery - Yes	CU450,000	CU400,000	CU50,000	DT liability of CU15,000
Employee benefits - Yes	(CU60,000)	–	CU60,000	DT asset of CU18,000
Trade receivables - Yes	CU235,000	CU250,000	CU15,000	DT asset of CU4,500

Including the deferred tax asset of CU2,700 (ie CU9,000[(d)] × 30%) for the unused tax losses of 20X0. SME A has a deferred tax asset of CU25,200 (ie CU2,700 + CU18,000 + CU4,500) and a deferred tax liability of CU15,000.

No valuation allowance is necessary against the deferred tax asset of CU25,200 as the entity has sufficient existing temporary differences that will result in future taxable amounts and expects to have sufficient future taxable profits to realise the deferred tax asset.

The deferred tax asset and liability may be offset as the temporary differences giving rise to the deferred tax asset reverse before those giving rise to the deferred tax liability. A net deferred tax asset of CU10,200 (ie CU25,200 less CU15,000) should be recognised.

(d) In the year ended 31 March 20X0, SME A made a tax loss of CU80,000. Of that tax loss, CU9,000 remains unused on 1 April 20X0 which cannot be carried back to prior years. This means that CU71,000 (ie CU80,000 less CU9,000) can be carried back to the years ended 31 March 20W8 and 20W9. SME A should recognise a current asset for the tax refund of CU21,300 (ie CU71,000 × 30%) on 31 March 20X0.

(e) Deferred tax assets and liabilities on 31 March 20X1:

Is recovery or settlement of the carrying amount of the item expected to affect taxable profit?	*Carrying amount*	*Tax basis*	*Temporary difference*	*Deferred tax @32%*
Machinery – Yes	CU400,000	CU300,000	CU100,000	DT liability of CU32,000
Research costs – Yes	–	CU4,000	CU4,000	DT asset of CU1,280
Employee Benefits – Yes	(CU50,000)	–	CU50,000	DT asset of CU16,000
Trade receivables – Yes	CU280,000	CU300,000	CU20,000	DT asset of CU6,400

SME A has a deferred tax asset of CU23,680 (ie CU1,280 + CU16,000 + CU6,400) and a deferred tax liability of CU32,000.

No valuation allowance is necessary against the deferred tax asset of CU23,680 because the entity has sufficient existing temporary differences that will result in future taxable amounts to realise the deferred tax asset.

The deferred tax asset and liability may be offset because the temporary differences giving rise to the deferred tax asset reverse before those giving rise to the deferred tax liability. A net deferred tax liability of CU8,320 should be recognised.

(f) If the tax rate had remained at 30 per cent, the net deferred tax liability would have been CU7,800 (ie 8,320[(e)] × 30 ÷ 32). Accordingly CU520 (ie CU8,320 less CU7,800) of the deferred tax expense is due to the change in tax rates from 30 per cent to 32 per cent. The remaining CU18,000 (ie CU18,520 less CU520) deferred tax expense is due to the origination and reversal of temporary differences.

Case study 2

On 1 January 20X5, entity A acquired 100 per cent of the shares of entity B at a cost of CU600,000. At the acquisition date the tax basis of entity A's investment in entity B is CU600,000. Reductions in the carrying amount of goodwill are not deductible for tax purposes, and the cost of the goodwill would also not be deductible if entity B were to dispose of its underlying business. The tax rate in entity A's tax jurisdiction is 30 per cent and the tax rate in entity B's tax jurisdiction is 40 per cent.

The following table sets out the fair value of the identifiable assets acquired and liabilities assumed (excluding deferred tax assets and liabilities) by entity A on 1 January 20X5, together with their tax bases in entity B's tax jurisdiction and the resulting temporary differences:

	Amounts recognised at acquisition in consolidated financial statements	*Tax basis in entity B's jurisdiction*	*Temporary differences*
	CU	*CU*	*CU*
Property, plant and equipment	270,000	155,000	115,000
Accounts receivable	210,000	210,000	–
Inventory	174,000	124,000	50,000
Retirement benefit obligations	(30,000)	–	(30,000)
Accounts payable	(120,000)	(120,000)	–
Fair value of the identified assets acquired and liabilities assumed excluding deferred tax	504,000	369,000	135,000

Part A
Calculate both the deferred tax liability acquired and the goodwill arising on acquisition of entity B.

Part B
In 20X5 entity B's equity (after incorporating the fair value adjustments that were made as a result of the business combination) changed as follows:

At 1 January 20X5	CU450,000
Retained profit for 20X5 (profit for the year CU70,000)	CU70,000
At 31 December 20X5	CU520,000

Calculate the amount of the deferred tax liability at 31 December 20X5 that is attributable to the temporary difference on entity A's investment in entity B (sometimes referred to as an 'outside basis' temporary difference).

Answer to case study 2

Part A

The deferred tax asset arising from the retirement benefit obligations is offset against the deferred tax liabilities arising from the property, plant and equipment and inventory (see paragraph 29.29 for offsetting requirements). Accordingly a net deferred tax liability of CU54,000—calculation 40% × CU135,000 (ie CU115,000 based on property, plant and equipment + CU50,000 based on inventory less CU30,000 based on retirement benefit obligations) will be recognised on entity B's individual assets and liabilities.

No deduction is available in entity B's tax jurisdiction for the cost of the goodwill. Consequently, the tax basis of the goodwill in entity B's jurisdiction is nil. However, paragraph 29.16(b) prohibits the recognition of a deferred tax liability on the initial recognition of goodwill.

Hence, on acquisition, the carrying amount of entity B in entity A's consolidated financial statements is made up as follows:

	CU
Fair value of identifiable assets acquired and liabilities assumed, excluding deferred tax	504,000
Deferred tax liability	(54,000)
Fair value of identifiable assets acquired and liabilities assumed	450,000
Goodwill	150,000
Carrying amount	600,000

Because, at the acquisition date, the tax basis in entity A's tax jurisdiction, of entity A's investment in entity B is CU600,000, there is no temporary difference in entity A's tax jurisdiction for the investment.

Part B

At 31 December 20X5 the carrying amount of entity A's underlying investment in entity B is as follows:

Net assets of entity B	CU520,000
Goodwill[(a)]	CU150,000
Carrying amount	CU670,000

[(a)] In this example the amortisation of goodwill has been ignored. In accordance with paragraph 19.23 goodwill must be amortised.

The temporary difference associated with entity A's underlying investment is CU70,000 (ie CU670,000 carrying amount less CU600,000 tax basis). This amount is equal to the cumulative retained profit since the acquisition date.

Unless entity B is a foreign subsidiary and entity A's investment is essentially permanent in duration, entity A would recognise a deferred tax liability for the temporary difference of CU70,000. Consequently, in most circumstances, entity A recognises a deferred tax liability of CU21,000 (ie CU70,000 × 30%) for the temporary difference arising due to the difference between the carrying amount of the investment in the consolidated financial statements and the tax basis of the investment.

Note: the deferred tax liability of CU21,000 is recognised in addition to any deferred tax recognised on the individual assets and liabilities of the subsidiary (eg changes in the deferred tax liability of CU54,000 recognised on entity B's inventory and property, plant and equipment and changes, in the deferred tax asset recognised on entity B's retirement benefit obligation).

Case study 3

Before 1 February 20X1 Group A consisted of a parent and a wholly-owned subsidiary (Subsidiary A) that the parent formed some years ago. With effect from 1 February 20X1 Group A also included Subsidiary B (see *Business combination* below). All entities are in the same tax jurisdiction and all have financial year ends of 31 December. The tax year in the jurisdiction also ends on 31 December. Group A files a consolidated tax return, as permitted in the jurisdiction, and is taxed on consolidated taxable profits.

Tax losses

The tax law permits entities to carry tax losses back two years and set them off against any taxable profits of those prior years. Tax law also permits any tax losses that cannot be carried back to be carried forward four years. Capital losses may only be set off against capital gains. A capital gain/loss is a gain/loss arising on the sale of a capital item (eg property, plant and equipment and investments).

At 31 December 20X0, Group A has unused tax losses of CU110,000 that cannot be carried back because Group A made losses in the last three years (CU40,000 of these losses are capital losses). On 31 December 20X0, Group A recognised a valuation allowance against the deferred tax asset resulting from the tax losses. None of the valuation allowance is attributable to the portion of the deferred tax asset relating to CU8,000 of the capital gains. The valuation allowance was created because the parent and its subsidiary are not expected to generate profits for the foreseeable future. However, CU8,000 of the capital losses are expected to be offset when the subsidiary sells one of its properties. The tax authorities permit losses of one group entity to be set against profits of another group entity.

Tax rates

In Group A's tax jurisdiction income tax rates have remained unchanged for many years. The standard income tax rate is 40 per cent. However, a tax rate of 20 per cent applies to any capital gains (capital gains tax).

Business combination

On 1 February 20X1, the parent acquired 100 per cent of the shares in another entity (Subsidiary B) in the same tax jurisdiction at a cost of CU400,000. At the acquisition date the tax basis of the parent's investment in Subsidiary B is CU400,000. Reductions in the carrying amount of goodwill are not deductible for tax purposes, and the cost of the goodwill would also not be deductible if the parent were to dispose of its underlying business.

The following table sets out the fair value of the identifiable assets and liabilities of Subsidiary B (excluding deferred tax assets and liabilities) as they are acquired by the parent on 1 February 20X1, together with their tax bases and the resulting temporary differences:

	Amounts recognised at acquisition in consolidated financial statements	*Tax basis*	*Temporary differences*
	CU	*CU*	*CU*
Property, plant and equipment	170,000	55,000	115,000
Accounts receivable	100,000	100,000	–
Inventory	74,000	44,000	30,000
Accounts payable	(110,000)	(110,000)	–
Fair value of identified assets and liabilities excluding deferred tax	**234,000**	**89,000**	**145,000**

Between 1 February 20X1 and 31 December 20X1, Subsidiary B made profits of CU100,000 (after adjustments for consolidation purposes, eg elimination of intragroup transactions such as Subsidiary B's dividend payment) that are recognised in the consolidated financial statements (the CU100,000 includes the impact of the change in Subsidiary B's deferred tax liability and the amortisation of goodwill). On 15 December 20X1, Subsidiary B declared a dividend of CU16,400 to the parent which will be paid in January 20X2. Withholding tax is charged on the dividend to the parent at 20 per cent. The parent is not further taxed on receipt of the dividend.

At the year end the assets and liabilities (excluding the deferred tax liability and goodwill) of Subsidiary B (as adjusted for consolidation, ie removal of intercompany balances etc) are as follows:

	Amounts to be recognised in consolidated financial statements on 31 December 20X1	*Tax basis*	*Temporary differences*
	CU	*CU*	*CU*
Property, plant and equipment	150,000	55,000	95,000
Accounts receivable	120,000	120,000	–
Inventory	85,000	85,000	–
Cash	80,000	80,000	–
Accounts payable and other payables	(115,000)	(115,000)	–
Assets and liabilities excluding deferred tax and goodwill	**320,000**	**225,000**	**95,000**

Subsidiary B has a financial year end of 31 December. Assume that at both 1 January and 31 December 20X1, all items of Subsidiary B's property, plant and equipment are expected to be used by Subsidiary B until the end of their useful lives and all items of Subsidiary B's inventory are expected to be sold in day-to-day business. Goodwill is amortised over 10 years with a full year of amortisation in the year ended 31 December 20X1.

Jointly-controlled entity

The parent has an investment in a foreign jointly controlled entity (JCE) which was purchased five years ago. The jointly controlled entity is based in a different tax jurisdiction. On 31 December 20X1, the carrying amount of the JCE in the consolidated financial statements is CU60,000 (measured using the equity method). The tax basis of the investment is CU40,000. The investment in the jointly controlled entity is essentially permanent in duration and there is no evidence that the temporary difference will reverse in the foreseeable

future.

Unused tax losses

Of the unused tax losses of CU110,000 existing at 1 January 20X1, the non-capital losses of CU70,000 may be set against Subsidiary B's profits between the acquisition date and 31 December 20X1. Because none of the group entities made any capital gains in the year, the capital losses cannot be used.

Subsidiary A expects to sell a property in 20X2 that will allow CU10,000 of the capital losses to be used (at the end of 20X0 it was expected that CU8,000 could be used). It is more likely than not that the remaining CU30,000 will expire unused.

Other assumptions

Assume that tax deductions on sale and use of assets are always equal. Also, assume that other than for the unused tax losses, jointly controlled entity, the parent's investment in Subsidiary B, and Subsidiary B's goodwill, property, plant and equipment and inventory, there are no assets, liabilities or other items that will affect the recognition and measurement of deferred tax.

Part A
Calculate both the deferred tax liability acquired and the goodwill arising on acquisition of Subsidiary B.

Part B
Prepare journal entries to show the changes between 1 February 20X1 and 31 December 20X1 to the deferred tax assets and liabilities determined in Part A relating to Subsidiary B's own assets and liabilities.

Part C
Prepare journal entries to show the changes between 1 February 20X1 and 31 December 20X1 to the goodwill determined in Part A which arose on acquisition of Subsidiary B.

Part D
Prepare journal entries to record the payment of the dividend from Subsidiary B to the parent entity. Consider the entries in both Subsidiary B's individual financial statements and Group A's consolidation financial statements.

Part E
Prepare journal entries to show the deferred tax asset and valuation allowance as at 1 January 20X1 and 31 December 20X1 and the movement in the year.

Part F
Prepare journal entries to recognise the deferred tax effect of the temporary differences

associated with unremitted earnings of Subsidiary B.

Part G
Prepare journal entries to recognise the deferred tax effect of the temporary differences associated with unremitted earnings of the foreign JCE.

Part H

Calculate the deferred tax expense/benefit for the year ended 31 December 20X1 and the deferred tax asset/liability as at 31 December 20X1.

Answer to case study 3

Part A

The deferred tax liability acquired as part of the assets and liabilities of Subsidiary B is CU58,000[(a)].

No deduction is available in the tax jurisdiction for the cost of the goodwill. Consequently, the tax basis of the goodwill is nil. However, paragraph 29.16(b) prohibits the recognition of a deferred tax liability on the initial recognition of goodwill.

Hence, on acquisition, the carrying amount of Subsidiary B in Group A's consolidated financial statements is made up as follows:

	CU
Fair value of identifiable assets acquired and liabilities assumed, excluding deferred tax	234,000
Deferred tax liability	(58,000)
Fair value of identifiable assets acquired and liabilities assumed	176,000
Goodwill (CU400,000 paid less CU176,000 identifiable net assets acquired)	224,000
Group carrying amount	400,000

On 1 February 20X1, no deferred tax arises from the parent's investment in Subsidiary B because equal taxable income and amounts deductible from taxable income would arise if the investment were to be sold for its carrying amount of CU400,000 on 1 February 20X1, having a nil net effect. This is because, the tax basis (ie available deductions on sale) of the parent's investment in Subsidiary B at this date is CU400,000.

Part B

The deferred tax liability on 31 December 20X1 on Subsidiary B's assets and liabilities is CU38,000[(b)]. The movement in the deferred tax liability between 1 February 20X1 and 31 December 20X1 is recognised as follows:

Dr	Deferred tax liability	CU20,000	
	Cr profit or loss—income tax (deferred tax)		CU20,000

To recognise the decrease in deferred tax liability on the year ended 31 December 20X1.

Part C

The tax basis of the goodwill is nil. The carrying amount of the goodwill is reduced to CU201,600[(c)] due to one year of amortisation. Consequently, the temporary difference is now CU201,600. However, subsequent reductions in a deferred tax liability that is unrecognised because it arises from the initial recognition of goodwill are also regarded as arising from the initial recognition of goodwill and are therefore not recognised. Consequently, no deferred tax liability is recognised for goodwill. The amortisation is recognised as follows:

Dr	Amortisation	CU22,400[(c)]	
	Cr Goodwill – accumulated amortisation		CU22,400

To recognise the amortisation of goodwill on the year ended 31 December 20X1.

Part D

Subsidiary B would make the following journal entries in the year ended 31 December 20X1 in its own financial statements for the dividend declared on 15 December 20X1:

Dr	Retained earnings – dividends paid	CU16,400	
	Cr Payable (amount due to parent)		CU13,120[(d)]
	Cr Payable (amount due to tax authority)		CU3,280[(d)]

To recognise the distribution of dividends.

Subsidiary B recognises a liability for the amount withheld that will need to be paid to the tax authorities and a liability for the net dividend payable to the parent. The payment to the tax authorities is income tax payable by the consolidated group. In Subsidiary B's financial statements, the full CU16,400 is considered to be a dividend payment to the parent.

On consolidation the above journal entries would be reversed and replaced with the journal entries below to show that the withholding tax payable is actually income tax payable by the consolidated group. The tax is effectively collected by Subsidiary B on the tax authority's behalf.

Dr	Income tax – current tax	CU3,280	
	Cr Current tax payable (amount due to tax authority)		CU3,280

To recognise the income tax liability.

Part E

The following journal entry is recognised in the year ended 31 December 20X1:

Dr	Valuation allowance	CU28,400[(e)]	
	Cr Deferred tax asset		CU28,000[(e)]
	Cr Income tax expense – deferred tax benefit		CU400[(e)]

To recognise the valuation allowance on the year ended 31 December 20X1.

On 31 December 20X0 Group A recognised a deferred tax asset of CU36,000[(e)] (with a valuation allowance recognised against it of CU34,400[(e)]) for its unused losses of CU110,000. This results in a net deferred tax asset of CU1,600. On 31 December 20X0, the possibility of using Subsidiaries B's profits to use the losses may not be considered because Subsidiary B has not yet been acquired. Only on 1 February 20X1 would this be allowed, and hence this will only be reflected as a reduction in the valuation allowance at the first reporting date after 1 February 20X1.

On 31 December 20X1 Group A has unused losses of CU40,000 and a deferred tax asset of CU8,000[(e)] with a valuation allowance set against if of CU6,000[(e)]. This results in a net deferred tax asset of CU2,000.

Part F

The entries in the consolidated financial statements for the year ended 31 December 20X1 are:

Dr	Income tax – deferred tax	CU16,720[f]	
	Cr Deferred tax liability		CU16,720[f]

To recognise the increase in deferred tax liability on the year ended 31 December 20X1.

The recovery of the carrying amount of a subsidiary either through sale or via receipt of dividend income will affect taxable profit. Consequently, deferred tax is accounted for. The temporary difference associated with the parent's underlying investment in Subsidiary B is CU83,600[f]. This amount is equal to the cumulative retained profit since the acquisition date.

Note: the deferred tax liability of CU16,720 is recognised in addition to the deferred tax liability of CU38,000 recognised on Subsidiary B's individual assets and liabilities.

Part G

The recovery of the carrying amount of the JCE through sale or earning dividend income would affect taxable profit. Group A should not recognise a deferred tax liability for the temporary difference of CU20,000[g] under paragraph 29.16(a) because the investment in the foreign JCE is essentially permanent in duration, and it is not apparent that the temporary difference will reverse in the foreseeable future.

Assuming that the exemption was also met on 1 January 20X1, there are no deferred tax entries to recognise in the year. If the exemption was not met on 1 January 20X1, any deferred tax asset/liability at that date relating to unremitted earnings of JCE should be derecognised in 20X1.

Part H (summary)

The movement in deferred tax assets and liabilities can be summarised as follows:

Dr	Deferred tax liability (Subsidiary B's PPE and inventory)	CU20,000	
Dr	Valuation allowance (unused losses)	CU28,400	
	Cr Deferred tax liability (investment in subsidiary)		CU16,720
	Cr Deferred tax asset (unused losses)		CU28,000
	Cr Income tax expense – deferred tax benefit		CU3,680[h]

To recognise the movement in deferred tax liability for the year ended 31 December 20X1.

The income tax expense for the year ended 31 December 20X1 relating to deferred tax is a benefit (credit) of CU3,680.

Group A should recognise a deferred tax asset for CU2,000. The deferred tax asset cannot be offset against the deferred tax liabilities existing at 31 December 20X1 because it relates to capital losses. The total deferred tax liability recognised by the group is CU54,720[i].

The calculations and explanatory notes below do not form part of the answer to this case study:

(a) Deferred tax liability = CU58,000 (ie (CU115,000 × 40%) + (CU30,000 × 40%)). The same deductions are available on use as on sale. Consequently, under paragraph 29.20 it is appropriate to use the use rate for the temporary difference arising on the property, plant and equipment and the sale rate for the temporary difference arising on the inventory. This is 40 per cent for both because a gain on sale of inventory is not a capital gain.

(b) Deferred tax liability = CU38,000 (ie (CU95,000 × 40%)) The same deductions are available on use as on sale. Consequently, under paragraph 29.20 it is appropriate to use the 40 per cent tax rate for the temporary difference arising on the property, plant and equipment.

(c) Carrying amount of goodwill at 31 December 20X1 after one year of amortisation is CU201,600 (ie CU224,000 × 9 ÷ 10). One year of amortisation is CU22,400 (ie CU224,000 × 1 ÷ 10).

(d) Subsidiary B recognises a financial liability for the amount withheld that will need to be paid to the tax authorities of CU3,280 (ie CU16,400 × 20%) and the net dividend payable to the parent of CU13,120 (ie CU16,400 less CU3,280).

(e) On 31 December 20X0, Group A has a deferred tax asset of CU36,000 (ie (CU70,000 × 40%) + (CU40,000 × 20%)) with a valuation allowance recognised against it for CU34,400 (ie (CU70,000 × 40%) + (CU32,000 × 20%)). This results in a net deferred tax asset of CU1,600 (ie CU36,000 less CU34,400).

On 31 December 20X1, Group A has a deferred tax asset of CU8,000 (ie CU40,000 × 20%) with a valuation allowance recognised against it for CU6,000 (ie (CU30,000 × 20%). This results in a net deferred tax asset of CU2,000 (ie CU8,000 less CU6,000).

Decrease in deferred tax asset in the year = CU28,000 (ie CU36,000 less CU8,000).

Decrease in valuation allowance = CU28,400 (ie CU34,400 less CU6,000).

Deferred tax benefit = CU400 (ie CU28,400 less CU28,000).

(f) The carrying amount of Subsidiary B on 31 December 20X1 is CU483,600 (ie CU400,000 cost + CU100,000 profit less CU16,400 dividend). The temporary difference is CU83,600 (ie CU483,600 less CU400,000). The group will recognise a deferred tax liability of CU16,720 (ie CU83,600 × 20%) for the temporary difference arising due to the difference between the carrying amount of the investment in the consolidated financial statements and the tax basis of the investment.

	CU
Goodwill	201,600 (c)
Property, plant and equipment	150,000
Accounts receivable	120,000
Inventory	85,000
Cash	80,000
Accounts payable	(115,000)
Deferred tax liability	(38,000) (b)
Carrying amount at 31 December 20X1	483,000
Carrying amount at 31 December 20X0	400,000
Cumulative retained earnings	83,000

(g) The temporary difference of the investment in the JCE is CU20,000 (ie the difference between the tax basis of CU40,000 and the carrying amount of CU60,000).

(h) Deferred tax benefit = CU3,680 (ie CU20,000 Part B + CU400 Part E less CU16,720 Part F).

(i) Deferred tax liability = CU54,720 (ie CU38,000 Part B + CU16,720 Part F).