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IAS® Standard 12 Income Taxes



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IAS® Standard 12 Income Taxes

SCOPE AND KEY DEFINITIONS

IAS Standard 12 Income Taxes prescribes the accounting treatment for income taxes. The recognition of assets and liabilities may have tax consequences when the entity recovers or settles their carrying amount. The fundamental principle of IAS 12 is that if it is probable that the recovery or settlement of this carrying amount will make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences, the Standard requires an entity to recognise a deferred tax liability (deferred tax asset), with certain limited exceptions.

This is because IFRS Standards may require the use of certain financial reporting policies that may not be recognized from a tax perspective. Therefore, differences may appear between the income tax calculated in financial statements according to IFRS Standards treatment, and income tax payable (i.e., established in accordance with the tax rules of each jurisdiction). If these differences are temporary (reversible over time), they are dealt with via the deferred tax mechanism and their treatment is treated in IAS 12.

Example 1

Determine any differences between the financial reporting and the tax treatments over the useful life of an equipment recognised in accordance with IAS 16 Property, Plant and Equipment, in each of the following two independent cases (accounting profit for the year is CU1,000; the applicable income tax rate is 16%):

- a) An entity purchases the equipment on 1.1.N for CU600. Its management estimates an even use of the asset, over 3 years, and no residual value. For tax purposes though, the asset is depreciated in 2 years, also by using the straight-line method.
- b) But what if the asset is depreciated in 2 years for financial reporting purposes, and in 3 years for tax purposes? The entity also uses the straight-line method of depreciation for both purposes.

Solution a)

Financial reporting depreciation schedule (in CU)			Tax depreciation schedule (in CU)		
Date	Annual depreciation	Carrying amount	Date	Annual tax depreciation	Tax base
1.1.N		600	1.1.N		600
31.12.N	200	400	31.12.N	300	300
31.12.N+1	200	200	31.12.N+1	300	0
31.12.N+2	200	0	31.12.N+2	0	0

Solution b)

Financial reporting depreciation schedule (CU)			Tax depreciation schedule (CU)		
Date	Annual depreciation	Carrying amount	Date	Annual tax depreciation	Tax base
1.1.N		600	1.1.N		600
31.12.N	300	300	31.12.N	200	400
31.12.N+1	300	0	31.12.N+1	200	200
31.12.N+2	0	0	31.12.N+2	200	0

Example 2

Discuss the extent to which differences between financial reporting and taxation treatments appear in each of the following cases, from an income tax perspective:

- A piece of equipment recognised in the entity's financial statements in accordance with IAS 16 is depreciated over 3 years, and it has a big residual value.
- A building recognised in accordance with IAS 16 is revalued; the revaluation is required by the tax authority.
- The First-In-First-Out (FIFO) method is used for assigning costs to inventories in the financial statements. FIFO is also recognized for the computation of the taxable profit.
- Accounts receivable are written down in the entity's financial statements. The adjustment is not tax deductible.
- The entity was fined. The fines are not deductible for tax purposes.

Solution

- difference
- no difference
- no difference
- difference
- difference

The following terms are used with the following meanings (IAS 12.5):

Accounting profit is profit or loss for a period before deducting tax expense. This amount is determined in accordance with financial reporting policies used to prepare the entity's financial statements.

Taxable profit (tax loss) is the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable).

Tax expense (tax income) is the aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax (see Figure 1).

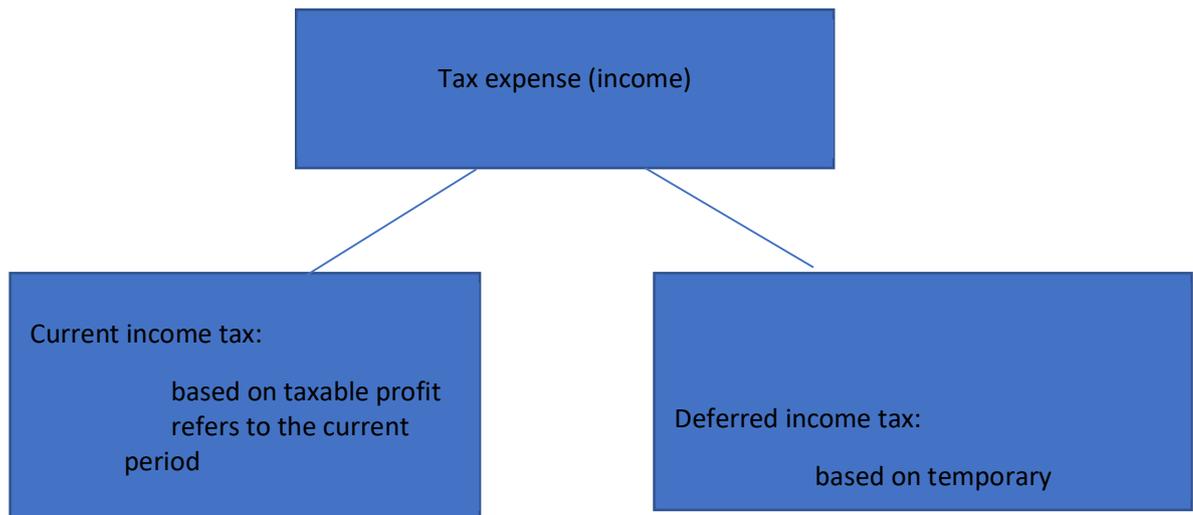
Current tax is the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period.

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

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

- a) deductible temporary differences;
- b) the carryforward of unused tax losses; and
- c) the carryforward of unused tax credits.

Fig. 1. Current and deferred income tax expense (income)



Temporary differences are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base.

Temporary differences may be:

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

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

The tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset. If the economic benefits are not taxable, the tax base of the asset is equal to its carrying amount.

The tax base of a liability is its carrying amount minus any amount that is deductible for tax purposes in respect of that liability in the future.

Table 1 details the rules for calculating the taxable (deductible) temporary differences for both assets and liabilities.

Table 1. Taxable (deductible) temporary differences determination

If	For assets	For liabilities
Carrying amount > Tax Base	Taxable temporary differences (TTD)	Deductible temporary differences (DTD)
Carrying amount < Tax Base	Deductible temporary differences (DTD)	Taxable temporary differences (TTD)

In the case of items that are not recognized as assets or liabilities in the statement of financial position, but they have a tax base as they will be deducted in the future from taxable profit, the outcome is a deductible temporary difference.

When applying IAS 12 to consolidated accounts, the carrying amount and the tax bases are those used in these accounts, where they are filed, or those in individual accounts in the absence of such filings.

Example 1 (cont.) How much is accounting and taxable profit in each year in Example 1 above? How much should tax expense be in each year? And how much is the current tax expense in each year?

Solution:

	a) N	a) N+1	a) N+2	a) Total tax	b) N	b) N+1	b) N+2	b) Total tax
Accounting profit is	1,000	1,000	1,000		1,000	1,000	1,000	
Tax expense should be	160*	160	160	480	160	160	160	480
Taxable profit is	1000+200-300=900**	900	1000+200=1200		1000+300-200=1100	1000+300-200=1100	1000-200=800	
Current tax expense is	144***	144	192	480	176	176	128	480

* Tax expense is based on the applicable income tax rate. So, tax expense should be CU1,000*16%

** Taxable profit is determined by removing from accounting profit any item that is not recognized from a tax perspective and by incorporating any item that is permitted by taxation authorities. Therefore, the year N taxable profit under case a) will be CU100 lower than the accounting profit, because of the larger depreciation deduction for tax purposes in that year. The year N taxable profit under case a) is CU1,000 + CU200 (to eliminate the financial reporting annual depreciation) – CU300 (to recognize the tax-deductible annual depreciation) = CU900

*** The current tax expense is based on the taxable profit * the income tax rate. Therefore, the year N current tax expense under case a) is CU900 * 16% = CU144.

The solution outlines the temporary differences appearing between the recognition of depreciation for financial reporting and tax purposes, respectively. One can note from the solution that by the end of the 3rd year, the equipment is completely depreciated according to both treatments, but the total amount of CU600 is spread across the years differently via the two depreciation schedules.

We also note that the total income tax paid is the same under both treatments, i.e., CU480, but the annual amounts paid differ year on year. Under case a), the annual payments in the early years are smaller than the tax expense (i.e., CU144 relative to CU160), and in the final year the payment exceeds the tax expense of that year (i.e., CU192 relative to CU160).

The situation is reversed under case b), where the first (last) payments exceed (is smaller than) the annual tax expense (i.e., CU176 ((CU128) instead of CU160). This illustrates how IAS 12 is used to free financial reporting from tax treatments. If we would base financial statements on the tax treatments, then the income tax rate would differ year on year, (i.e., $144/1,000\%=14.4\%$ in years N and N+1, respectively $192/1,000\%=19.2\%$ in year N+2 under scenario a), and this is not accurate from a financial reporting perspective, because the financial reporting treatments have not changed during the period, and the income tax rate should be 16% in each year.

Example 2 (cont.) Are the differences identified in example 2 above temporary or permanent?

Solution

a) temporary; timing differences occur between the recognition of depreciation in financial statements and tax returns; see Example 1 above.

d) temporary; since the write down was not tax deductible when it was recognized, the resulting reversal will not be taxable

e) permanent; as fines are not recognized for tax purposes, there will always be a difference between its recognition for financial reporting purposes and for tax purposes. This difference never results in a temporary difference.

Example 1 (cont.) What are the temporary/deductible temporary differences (TTD/DTD) in Example 1 above?

Solution

a)

Date	Carrying amount	Tax base	TTD	DTD
31.12.N	400	300	100*	-
31.12.N+1	200	0	200	-
31.12.N+2	0	0	0	-

b)

Date	Carrying amount	Tax base	TTD	DTD
31.12.N	300	400	-	100**
31.12.N+1	0	200	-	200
31.12.N+2	0	0	-	0

*When the carrying amount of an asset exceeds its tax base, a taxable temporary difference is recognized. This is in application of the standard's fundamental principle; specifically, it appears that, under scenario a), the tax payment in the year of the recovery of the asset's carrying amount (N+2) is larger than it would be if such recovery were to have no tax consequences (i.e., CU192 instead of CU160). Hence, a taxable temporary difference appears.

** Conversely, under scenario b), the tax payment in the year of the recovery of the asset's carrying amount (N+2) is smaller than it would be if such recovery were to have no tax consequences (i.e., CU128 instead of CU160). Hence, a deductible temporary difference appears.

If the recovery of the asset or the settlement of a liability will have no tax consequences, then the item's tax base equals its carrying amount.

If the corresponding line (of the asset or liability) is a revenue, and:

- if the revenue is taxable in the future, the deductible amount is 0;
- if the revenue is not taxable in the future (e.g., because it was already taxed, or the corresponding expense was not tax deductible), the deductible amount is the amount of the revenue.

Example 3 What are the resulting temporary differences in each of the following cases, as at 31.12.N?

- 1) equipment was purchased at the beginning of year N-1, for CU1,000, and was recognized as such under IAS 16. For accounting purposes, the item is depreciated on a straight-line basis, for 5 years; from a tax perspective, it is depreciated on a straight-line basis as well, but for 4 years.
- 2) accounts receivable is CU1,000; corresponding revenues are recognized for tax purposes when they are recognized in accounting.
- 3) prepaid expenses of CU500 – representing rent prepaid in year N for N+1; the amount is tax deductible when it is recognized in accounting.
- 4) fines payable CU200; the fines are not tax deductible.
- 5) deferred income CU300 – representing royalties received in advance in year N, for year N+1; the revenue is taxed when it is recognized in accounting.
- 6) deferred income CU1,500 – representing interest received in advance in year N, for year N+1; the amount is taxed on a cash basis.
- 7) warranty provisions of CU600, of which CU200 are tax deductible when they are recognized in accounting.

Solution

Item	Nature of item (A/L)	Carrying amount	Tax base	TTD	DTD
Equipment	A ¹	600	500	100	-
Accounts receivable	A ²	1000	1000	-	-
Prepaid expenses	A ³	500	500	-	-
Fines payable	L ⁴	200	200-0=200	-	-
Deferred income CU300	L ⁵	300	300-0=300	-	-
Deferred income CU1,500	L ⁶	1500	1500-1500=0	-	1500
Warranty provisions	L ⁷	600	600-400=200	-	400
Total				100	1900

¹ the annual depreciation financial reporting purposes is CU200, and the asset is depreciated for two years; the annual tax depreciation is CU250, again for two years

²the recovery of this asset does not have a tax consequence, so the asset's tax base is its carrying amount

³the amount will be taxed in the future, when the entity realises the asset; since this is the same year for both treatments, the tax base is 500

⁴ fines are never tax deductible. Therefore, their tax base is CU200 (carrying amount minus any amount that will be deductible in the future; in this case, nothing is deductible)

⁵ since the revenue is taxable in the future (i.e., when it is recognized in accounting), the deductible amount is 0

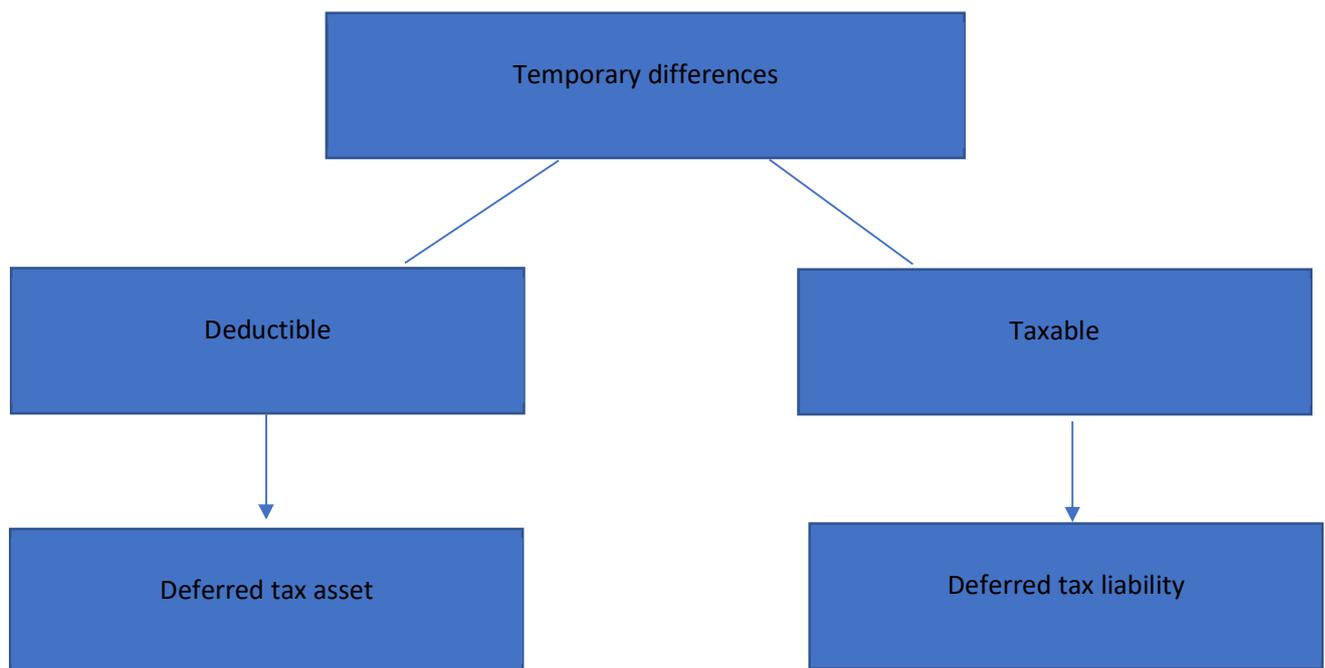
⁶ since the revenue was already taxed, its entire amount will be tax exempt (deductible) in the future

⁷ since CU200 are tax deductible when they are recognized in accounting, CU400 are not tax deductible when they are recognized in accounting; therefore, CU400 will be tax exempt when the liability is settled (and the provision is reversed).

A deferred tax asset shall be recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised (IAS 12.24).

A deferred tax liability shall be recognised for all taxable temporary differences, with certain exceptions (IAS 12.15). Figure 2 details these rules.

Figure 2. Consequences of temporary differences



Deferred tax assets and liabilities are not discounted (IAS 12.53).

Example 1 (cont.) What are the deferred tax implications in Example 1 above and the resulting tax expense?

Solution:

A) As at 31.12.N, a taxable temporary difference of CU100 was calculated. Therefore, a deferred tax liability of CU16 should be recognized, by recording a deferred tax expense for the amount.

Dr. Deferred tax expense 16
 Cr. Deferred tax liability 16

Tax expense = Current tax expense + deferred tax expense/-deferred tax income

Tax expense N = 144 + 16 = CU160

As at 31.12.N+1, a taxable temporary difference of CU200 was calculated. Therefore, a deferred tax liability of CU32 is required. A deferred tax liability of CU16 was already recognised at the end of year N, thus the entity must increase this liability to CU32 (an addition of CU16), by recording a deferred tax expense for the amount in N+1.

Dr. Deferred tax expense 16
 Cr. Deferred tax liability 16

Tax expense N+1 = 144 + 16 = CU160

As at 31.12.N+2, a taxable temporary difference of nil was calculated. Therefore, there is no need to have any deferred tax liability at the end of that year. A deferred tax liability of CU32 was already recognised at the end of year N+1, thus the entity must decrease this liability by its full amount of CU32, by recording a deferred tax income for the amount.

Dr. Deferred tax liability 32
 Cr. Deferred tax income 32

Tax expense N+2 = 192 - 32 = CU160

B)

As at 31.12.N, a deductible temporary difference of CU100 was calculated. Therefore, a deferred tax asset of CU16 should be recognized, by recording deferred tax income for the amount.

Dr. Deferred tax asset 16
 Cr. Deferred tax income 16

Tax expense = Current tax expense + deferred tax expense/-deferred tax income

Tax expense N = 176 - 16 = CU160

As at 31.12.N+1, a deductible temporary difference of CU200 was calculated. Therefore, a deferred tax asset of CU32 is required. A deferred tax asset of CU16 was already recognised at the end of year N, thus the entity only needs to increase this asset to CU32 (an addition of CU16), by recording a deferred tax income for the amount.

Dr. Deferred tax asset 16
 Cr. Deferred tax income 16

Tax expense N+1 = 176 - 16 = CU160

As at 31.12.N+2, a deductible temporary difference of nil was calculated. Therefore, there is no need to have any deferred tax asset at the end of that year. A deferred tax asset of CU32 was already recognised at the end of year N+1, thus the entity must decrease this asset by its full amount of CU32, by recording a deferred tax expense for the amount.

Dr. Deferred tax expense 32
 Cr. Deferred tax asset 32

Tax expense N+2 = 128 + 32 = CU160

As such, the total tax expense, comprising both current and deferred tax expense, stands at 16% of accounting profit each year.

Current and deferred tax shall be recognised as income or an expense and included in profit or loss for the period, except to the extent that the tax arises from a transaction or event which is recognised, in the same or a different period, outside of profit or loss, either in other comprehensive income or directly in equity (IAS 12.58)

Current tax and deferred tax shall be recognised outside profit or loss if the tax relates to items that are recognised, in the same or a different period, outside profit or loss. Therefore, current tax and deferred tax that relate to items that are recognised, in the same or a different period in other comprehensive income (equity), shall be recognised in other comprehensive income (equity) (IAS 12.61A)

Example 4 The following information relates to the end of years N and N+1:

	End of N	End of N+1
Taxable temporary difference	CU10,000	CU8,000
Deductible temporary difference	6,000	9,000

A deferred tax liability of CU1,000 existed at the beginning of year N. The applicable income tax rate is 16%.

- 1) What are the deferred taxes resulting for the two years, and how should the entity journalize their effect?
- 2) What would it be different if the entity had revalued its land properties during N+1, which generated a taxable temporary difference of CU1,500?

Solution

- 1) **Year N**

A taxable temporary difference of CU10,000 was calculated at the end of year N a deferred tax liability of CU1,600 is needed; at the same date, a deferred tax liability of CU1,000 exists the entity must increase deferred tax liabilities by CU600

Dr. Deferred tax expense 600
Cr. Deferred tax liability 600

A deductible temporary difference of CU6,000 was calculated at the end of year N a deferred tax asset of CU960 is needed; there was no beginning balance for deferred tax asset for year N the entity must increase deferred tax assets by CU960

Dr. Deferred tax asset 960
Cr. Deferred tax income 960

Year N+1

A taxable temporary difference of CU8,000 was calculated at the end of year N+1 a deferred tax liability of CU1,280 is needed; at the same date, a deferred tax liability of CU1,600 already exists the entity must decrease its deferred tax liability by CU320

Dr. Deferred tax liability 320
Cr. Deferred tax income 320

A deductible temporary difference of CU9000 was calculated at the end of year N+1 a deferred tax asset of CU1,440 is needed; there is a beginning balance for deferred tax assets for the year of CU960 the entity must increase its deferred tax asset by CU480

Dr. Deferred tax asset 480
Cr. Deferred tax income 480

2) Year N+1 only

Since the revaluation resulted in a taxable temporary difference of CU1,500 (i.e., the carrying amount of the asset exceeded its tax base), the entity must have revalued its land property for financial reporting purposes, without this being accepted by the tax authorities. Therefore, the entity must have recorded the revaluation as follows:

Dr. Land 1,500
Cr. Revaluation reserve 1,500

At the same time, since this revaluation will have future income tax implications, the entity also recognized a taxable temporary difference resulting from the revaluation, of CU240 (1500*16%). However, instead of recognizing it in profit or loss as a deferred tax expense, the entity recognizes it directly in equity, as the supporting transaction was recorded in equity:

Dr. Deferred tax recognized in equity 240
Cr. Deferred tax liability 240

Therefore, at year N+1 end, when a taxable temporary difference of CU8,000 is calculated, a deferred tax liability of CU1,280 is needed; at the same date, a deferred tax liability of $CU1,600+240=CU1,840$ exists the entity must decrease its deferred tax liability by CU560:

Dr. Deferred tax liability 560
 Cr. Deferred tax income 560

DISCLOSURE

An entity shall separately disclose the components of tax expense (income), such as, for example, current tax expense (income) and deferred tax expense (income). Additionally, entities must disclose aggregate amounts of tax recognised directly in equity or related to each item of other comprehensive income.

An entity shall also disclose separately an explanation of the relationship between tax expense (income) and accounting profit. The average effective tax rate is the tax expense (income) divided by the accounting profit.

Example 5

Merchandise is held at the end of the years N and N+1 for CU1,000. The net realisable value of this merchandise is CU950 as at December 31 year N, and CU1,050 as at December 31 year N+1. The value adjustments for inventory write-downs are not tax deductible. The accounting profit of each year is CU500. The applicable income tax rate is 16%. Determine any deferred taxes and explain their impact on the financial statements (i.e., determine tax expense).

Solution

Year N

According to IAS 2 Inventories, these items are measured at the lower between their cost and their net realisable value. Therefore, this merchandise inventory is measured at CU950 in the financial statements prepared at the end of year N (lower of their cost of CU1,000 and their NVR of CU950). At the same date, the asset's tax base is CU1,000, as the write down is not tax deductible.

As the asset's carrying amount is smaller than its tax base, a deductible temporary difference of CU50 results the entity will recognize a deferred tax asset of CU8.

Dr. Deferred tax asset 8
 Cr. Deferred tax income 8

Tax expense is composed of current tax expense and deferred tax expense or income.

Current tax expense is based on the taxable profit.

The year N taxable profit is $CU500+CU50=CU550$, as the write down expense is not tax deductible
current tax expense is $CU550*16%=CU88$

Tax expense is $CU88-CU8$ (deferred tax income) = CU80.

Also, this is $16%*CU500$ (accounting profit).

Year N+1

At the end of year N+1, based on the same inventory measurement requirement, the merchandise inventory is measured at CU1,000 (lower of cost 1,000 and net realisable value of 1,050). Because of this, the entity must revert the write down it previously recognized. Since the write down was not tax deductible, its reversal will be tax exempt.

So, since the asset's carrying amount equals its tax base at CU1,000, there is no temporary difference; however, a deferred tax asset of CU8 exists for this asset at the beginning of the year, and this deferred tax asset should now be cancelled.

Dr. Deferred tax expense 8
 Cr. Deferred tax asset 8

The year N+1's taxable profit is $CU500 - CU50 = CU450$, as the reversal of the write down is not taxable current tax expense is $CU450 * 16\% = CU72$

Tax expense is $CU72 + CU8$ (deferred tax expense) = $CU80$.
Also, this is $16\% * CU500$ (accounting profit).