South African Institute of Taxation

Back to the future

A conversation about deferred tax

YOUR KEY TO THE TAX COMMUNITY

Welcome

On the lunch plate today

1. Tax focus points touching on deferred tax
   a) Are there any?

2. Accounting focus points touching on deferred tax (S29 of IFRS for SMEs)
   a) **What is** deferred tax, and **why** calculate it?
   b) **Accounting tax bases** versus **tax values** for assets and liabilities
   c) **Some interesting scenarios** to take note of
   d) **Practical application** through examples

3. Conclusionary remarks

Tax focus points touching on deferred tax

Are there any?

- ✓ I need to know my tax legislation and principles…!
- ✓ Specific to the jurisdiction of the governing tax authority
- ✓ Always know that SARS is interested in real taxes, actually payable by law
- ✓ Deferred tax is an **internationally-performed accounting book entry**
  - Based on local tax legislation and principles for purposes of measurement

Accounting focus points touching on deferred tax

What is deferred tax, and why calculate it?

- ✓ The reality is… most accountants do not enjoy dealing with deferred tax

- ✓ **Section 29** (IFRS for SMEs) has been completely aligned with **IAS 12** (full IFRS)
  - Complexly written, long and not enough examples

- ✓ The only way to really understand deferred tax, is to understand **what it really is**, and **why it is calculated**? Then only, the **how to** will follow naturally…

- ✓ The best approach is to **break the topic into sections**, and understand chunk by chunk
  - What deferred tax is (i.e., the bigger picture)
  - Why deferred tax is calculated (i.e., does it make sense?)
  - Focusing on assets and liabilities, rather than income and expenses
  - Assigning (accounting) tax bases to assets and liabilities
    - o Versus (real tax) tax values?
  - What does a comparison between the carrying amount (CA) and tax base (TB) of an asset or liability mean in the financial statements?
    - o The role of differences between CAs and TBs of assets and liabilities

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What is deferred tax, and why is it calculated?

Where it all starts…

- ✓ A better term for 'deferred tax' would have been **future tax**
- ✓ But how can I recognise **future tax** now already? *It does not make sense, or does it?*
  - Assets and liabilities (i.e., the balance sheet/SoFP) **relate to the future**
  - The net asset value (NAV = Assets less Liabilities) = capacity of the entity to generate net **future** economic benefits (positive (profits) or negative (losses))
  - Assets and liabilities are **present** (i.e., a *present* economic right, a *present* obligation), but deferred tax on these, is not – why then recognise?
    - Realisation of assets = **probable** (more likely than not), and not guaranteed, yet they are recognised (think: debtors, inventory, manufacturing equipment)
    - Settlement of liabilities = **probable** (more likely than not), and not guaranteed, yet they are recognised (think: constructive obligations, provisions)
  - Measurement of assets and liabilities = **pre-tax**, so the NAV is overstated!
  - **Deferred (future) tax changes a pre-tax NAV to a post-tax NAV**

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Is a deferred tax liability, really a liability?

If not, what could it be?

- ✓ Test against the definition of a liability (differing views)
  - Present obligation? “No realistic alternative but to settle” = **No**
  - The settlement of which is expected to lead to an outflow of economic benefits from the entity = **Yes**
  - Result: definition not satisfied ☹
- ✓ My personal view
  - **Deferred tax debit** = asset (probable future economic benefits in the form of tax savings/deductions accruing to the entity
  - **Deferred tax credit** = ‘negative asset’ (i.e., valuation adjustment (similar to an impairment)) representing the <u>net</u> future tax consequences of realising assets (i.e., recovering their carrying amounts) and settling liabilities (i.e., paying their carrying amounts)
  - Assets and liabilities are measured pre-tax in terms of IFRS/IFRS for SMEs
    - o *Should this ever change to post-tax, the need for deferred tax would be abolished*

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The process of calculating deferred tax

What are the important steps to follow?

Step 1: First finalise the CAs of assets and liabilities according to IFRS or IFRS for SMEs

Step 2: Assign a TB to all assets and liabilities, also those not on the trial balance

- E.g., assessed loss for which expectation of future tax saving exists

Step 3: Assess the difference between the CA and the TB, if any

- Is there a justifiable difference? (i.e., accrual basis versus cash basis)
- Is the difference permanent or temporary in nature?

Step 4: Decide on an appropriate amount of deferred tax to assign to each relevant A/L

- Only *temporary* differences are assigned deferred (future) tax
- Sometimes not even temporary differences are assigned deferred (future) tax

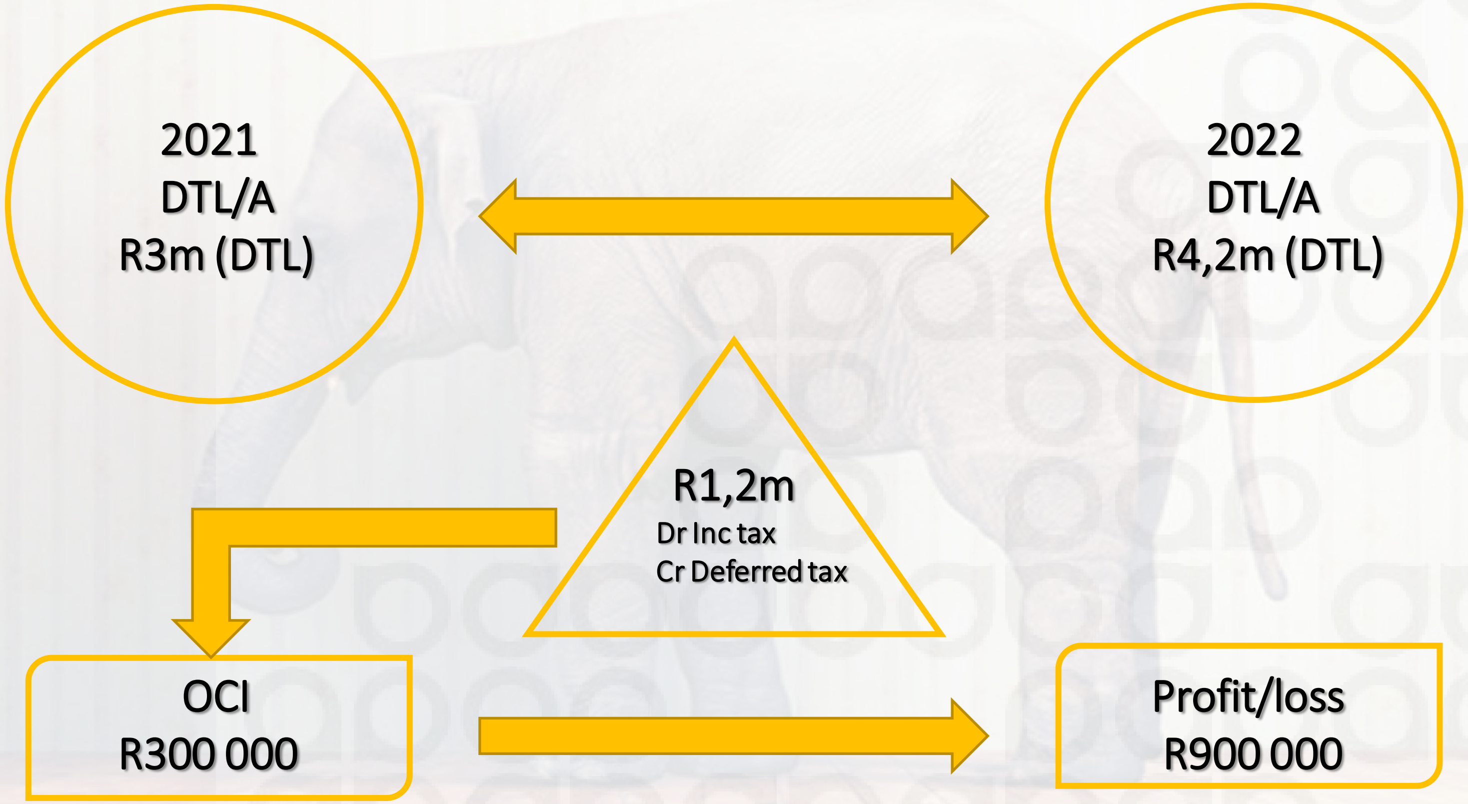
Step 5: Compare the position at year-end to the previous year-end

- What movement took place?
- Where did the movement arise?
    - Through OCI (e.g., fair value adjustments (revaluations), etc.)
    - Through P/L (the balance)

Visualising the process

An important picture to remember

The assets and liabilities approach (per IFRS and IFRS for SMEs)



P&L approach versus A&L approach

Thinking in line with IFRS and the IFRS for SMEs

~~Profit and loss approach~~

~~Profit before tax~~	~~100~~
~~Permanent differences~~	~~(8)~~
~~Taxable temp. diff's (TTDs)~~	~~(5)~~
• ~~Plus: depreciation~~	~~5~~
• ~~Less: wear-and-tear~~	~~(10)~~
~~Taxable income~~	~~87~~
~~Current tax, at 28%~~	~~24,36~~
~~Deferred tax on TDs, at 28%~~	~~1,40~~
~~Total tax (P/L)~~	~~25,76~~
~~*Effective tax rate*~~	~~*25,76%*~~

Assets and liabilities approach

	CA	TB	TD	DTL/(A)
Asset 1	700	500	200	56,0 L
Asset 2	120	150	(30)	(8,4) (A)
Liability 1	(40)	-	(40)	(11,2) (A)
Net position	**780**	**650**	**130**	**36,4 DTL**

?

Calculating an (accounting) tax base for A&L's

Based on IFRS requirements

Rule 1: The tax base of an asset

The amount deductible for tax purposes against any future taxable benefits recovered from the asset

- *NB: How can the CA of an asset be recovered? Use, sale, or both!*
- *NB: What if the future economic benefits recovered are not taxable?*

Rule 2: The tax base of a liability

Equals the CA of the liability, less any amount that is <u>deductible</u> for tax purposes <u>in future</u>

- *NB: Effectively leaves us with what is deductible, for tax purposes, right now…*

Rule 3: The tax base of income received in advance

Equals the CA of the liability, less any amount <u>not taxable</u> for tax purposes <u>in future</u>

- *NB: Not taxable in future could also mean the amount has already been taxed before!*

Tax bases

Some examples to think of…

	CA	TB	TD	DTL/(A)
Assets				
Equipment (@ historic CA)	R120m	?		
Trade receivables	R80m	?		
Bank and cash balances	R20m	?		
Trade receivables	R9m	R9,75m	(R750k)	(R210k)
➢ Gross *(treat like asset)*	R10m	R10m		
➢ Allowance for d/debts *(treat like liability)*	(R1m)	(R250k)		
Pre-S13quin admin building (@ historic CA)	R200m	?		
Assessed loss (R100m, expected future taxable income)	-	?		
Liabilities				
Long-term loan	(R100m)	?		
Provision for bonuses	(2m)	?		
• *SARS is on cash basis*				
Income received in advance				
Income received in advance	(R10m)	?		
• *SARS taxes at the earlier of accrual or cash received*				

Analysing CAs and TBs

What does it mean?

Assets

CA > TB → Future tax payable = DTL

CA < TB → Future tax saving = DTA

Liabilities

CA > TB → Future tax saving = DTA

CA < TB → Future tax payable = DTL

Income received in advance

CA > TB → Future tax saving = DTA

CA < TB → Future tax payable = DTL

Ensure that differences are justified, temporary and will reverse

Bringing measurement into the mix

Some very important principles to remember!

✓ Deferred tax in the balance sheet (SoFP) must reflect:

- the future tax consequences
  - whatever these may be (e.g., income tax, CGT, etc.)
- of realising an asset
  - most often leads to taxable income
- or settling a liability
  - most often leads to tax savings
- according to the method of realisation/settlement
  - assets: use, sale, combination of use and sale
  - liabilities: simpler, as usually settled in cash, sometimes through performance
- limited to the carrying amount reflected on the balance sheet (SoFP)
  - potential amounts are irrelevant, as recognising tax on these potential amounts cause mismatches with CAs on the balance sheet (SoFP) (e.g., potential sales amounts versus CAs)

Fair value adjustments

Example 1

✓ **The tax base of revalued land?**

- Revalued carrying amount = R3 million
- Original cost price (and base cost, for CGT purposes) = R2 million

- *Tax base = amount deductible for tax purposes* ***in future****, when land is recovered*
  - o Land = non-depreciable asset, hence only recovered through sale
  - o Tax consequences = possible capital gains tax (CGT) when land is **sold**

- Hence, when land is **sold** (at R3m, which is the CA) – what will be **deductible** against the R3m **proceeds**?
  - o The base cost R2 000 000
  - o 20% of capital gain not taxable: [(R3m – R2m) x 20%] R200 000
  - o Tax base R2 200 000

Carrying amount	R3 000 000
Tax base	R2 200 000
TD	R800 000
DTL	R224 000

TEST THE ANSWER

CGT = [Proceeds less base cost] x 80% x 20%

= [R3m – R2m] x 80% x 28%

= R224 000

Fair value adjustments

Example 2

✓ **The tax base of revalued manufacturing buildings?**

- Revalued carrying amount = R50 million (residual value: R25 million)
- Original cost price (and base cost, for CGT purposes) = R20 million
- Unclaimed capital deductions (based on historic cost) = R12 million

- *Tax base = amount deductible for tax purposes **in future**, when buildings are recovered*
  - Buildings = depreciated to residual value, hence recovered through use and sale
  - Tax consequences = capital deductions (during use); recoupments and/or CGT when sold

- Hence, what can be deducted for tax purposes in future?

o Unclaimed capital deductions	R12 000 000
o 20% of capital gain not taxable: [(R25m (DSP) – R20m (OCP) x 20%]	R1 000 000
o Tax base	R13 000 000

• Carrying amount:	R50 000 000
• Tax base:	R13 000 000
• Temporary difference:	R37 000 000
• Deferred tax liability:	**R10 360 000** *(i.e., tax expected to pay in future)*

Fair value adjustments

Example 2 (continued)

Analysis and proof

Carrying amount	R50 000 000
Residual value	R25 000 000
Original cost price	R20 000 000
Unclaimed W&T	R12 000 000

R25 000 000 **(use)**

R25 000 000 **(sale)**

NB!!

TEST THE ANSWER: what are the actual tax consequences of use and sale?

- ✓ Tax on revenue through **use** = [(R50 000 000 – R25 000 000 (RV)) x 28%] = R7 000 000
- ✓ Recoupment due to **sale** = Selling price, limited to original cost price, less tax value
  - [~~R25m~~ R20m – R12m] x 28% = R2 240 000
- ✓ CGT due to **sale** = [**Proceeds** less **base cost**] x 80% x 28%
  - = ([R25m (SP) – R8m (Rec)] less [R20m (OCP) – R8m (Total cap ded.)] x 80% x 28% = R1 120 000
- ✓ Total tax payable in future = R10 360 000

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Sometimes the tax base rules don't apply

Most often related to TDs on which no DT is recognised…

- ✓ Be especially careful about recognition of **deferred tax assets**

- ✓ If a deferred tax asset arises from an ***assessed loss***, will there be sufficient future taxable income against which the assessed loss can be utilised to effect a tax saving?
  - This could even be the case partially
  - Consider ringfencing of assessed losses in group structures
  - *Deferral of assessed losses?*

- ✓ If a deferred tax asset arises from ***deductible temporary differences*** (i.e., temporary differences that increase the taxable income), the deferred tax asset is limited to the amount of taxable temporary differences in the current and future periods against which the deductible temporary differences can be utilised/reversed

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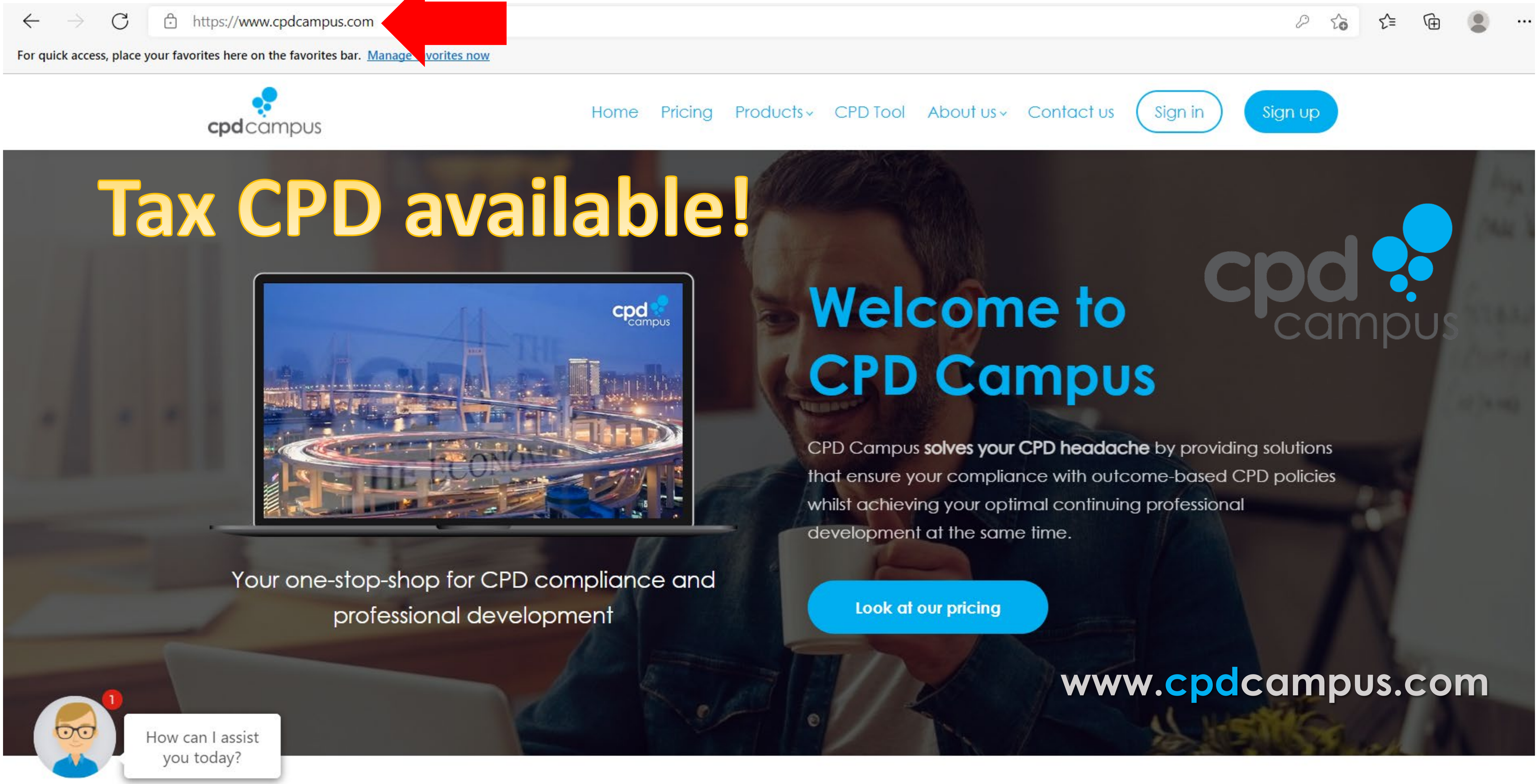
Tax CPD available!



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