

*Hong Kong Accounting Standard 12*

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# Income Taxes



Hong Kong Institute of  
**Certified Public Accountants**  
香港會計師公會

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Hong Kong Accounting Standard 12 *Income Taxes* (HKAS 12) is set out in paragraphs 1-99. All the paragraphs have equal authority. HKAS 12 shall be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Conceptual Framework for Financial Reporting*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

## Introduction

IN1 HKAS 12 is effective for accounting periods beginning on or after 1 January 2005. The major features of HKAS 12 are as follows.

IN2 HKAS 12 requires an entity to account for deferred tax using the balance sheet liability method, which focuses on temporary differences. Temporary differences are differences between the tax base of an asset or liability and its carrying amount in the statement of financial position. The tax base of an asset or liability is the amount attributed to that asset or liability for tax purposes.

IN3 HKAS 12 requires an entity to recognise a deferred tax liability or (subject to certain conditions) asset for all temporary differences, with certain exceptions noted below.

IN4 HKAS 12 requires that deferred tax assets should be recognised when it is probable that taxable profits will be available against which the deferred tax asset can be utilised. Where an entity has a history of tax losses, the entity recognises a deferred tax asset only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available.

IN5 As an exception to the general requirement set out in paragraph IN3 above, HKAS 12 prohibits the recognition of deferred tax liabilities and deferred tax assets arising from certain assets or liabilities whose carrying amount differs on initial recognition from their initial tax base.

IN6 An entity shall recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, except to the extent that both of the following conditions are satisfied:

- (a) the parent, investor, joint venturer or joint operator is able to control the timing of the reversal of the temporary difference; and
- (b) it is probable that the temporary difference will not reverse in the foreseeable future.

Where this exception has the result that no deferred tax liabilities have been recognised, HKAS 12 requires an entity to disclose the aggregate amount of the temporary differences concerned.

IN7 HKAS 12 prohibits the recognition of deferred tax liabilities arising from the initial recognition of goodwill.

IN8 HKAS 12 requires an entity to recognise a deferred tax liability in respect of asset revaluations.

IN9 The tax consequences of recovering the carrying amount of certain assets or liabilities may depend on the manner of recovery or settlement, for example:

- (a) in certain countries, capital gains are not taxed at the same rate as other taxable income; and
- (b) in some countries, the amount that is deducted for tax purposes on sale of an asset is greater than the amount that may be deducted as depreciation.

HKAS 12 requires that the measurement of deferred tax liabilities and deferred tax assets should be based on the tax consequences that would follow from the manner in which the entity expects to recover or settle the carrying amount of its assets and liabilities.

## INCOME TAXES

- IN10 HKAS 12 prohibits discounting of deferred tax assets and liabilities.
- IN11 HKAS 12 requires that an entity which makes the current/non-current distinction should not classify deferred tax assets and liabilities as current assets and liabilities.<sup>¶</sup>
- IN12 HKAS 12 establishes more restrictive conditions on offsetting, based largely on those for financial assets and liabilities in HKAS 32 *Financial Instruments: Presentation*.
- IN13 HKAS 12 requires an explanation of the relationship between tax expense and accounting profit if not explained by the tax rates effective in the reporting entity's country to take either or both of the following forms:
- (a) a numerical reconciliation between tax expense (income) and the product of accounting profit multiplied by the applicable tax rate(s); or
  - (b) a numerical reconciliation between the average effective tax rate and the applicable tax rate.

HKAS 12 also requires an explanation of changes in the applicable tax rate(s) compared to the previous accounting period.

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<sup>¶</sup> This requirement has been moved to paragraph 56 of HKAS 1 *Presentation of Financial Statements*.

## Hong Kong Accounting Standard 12 *Income Taxes*

### Objective

The objective of this Standard is to prescribe the accounting treatment for income taxes. The principal issue in accounting for income taxes is how to account for the current and future tax consequences of:

- (a) the future recovery (settlement) of the carrying amount of assets (liabilities) that are recognised in an entity's statement of financial position; and
- (b) transactions and other events of the current period that are recognised in an entity's financial statements.

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 or liability. 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, this Standard requires an entity to recognise a deferred tax liability (deferred tax asset), with certain limited exceptions.

This Standard requires an entity to account for the tax consequences of transactions and other events in the same way that it accounts for the transactions and other events themselves. Thus, for transactions and other events recognised in profit or loss, any related tax effects are also recognised in profit or loss. For transactions and other events recognised outside profit or loss (either in other comprehensive income or directly in equity), any related tax effects are also recognised outside profit or loss (either in other comprehensive income or directly in equity, respectively). Similarly, the recognition of deferred tax assets and liabilities in a business combination affects the amount of goodwill arising in that business combination or the amount of the bargain purchase gain recognised.

This Standard also deals with the recognition of deferred tax assets arising from unused tax losses or unused tax credits, the presentation of income taxes in the financial statements and the disclosure of information relating to income taxes.

#### General Principles

- This Standard deals with current taxes and deferred taxes. Some general principles relating to the treatment of deferred taxes in this Standard are set out below.
- The future tax consequences of transactions and other events recognised in an entity's statement of financial position give rise to deferred tax liabilities and assets, and are calculated in accordance with the following formulae:

$$\text{Carrying amounts of assets or liabilities} - \text{Tax bases of assets or liabilities} = \text{Taxable or deductible temporary differences}$$

$$\text{Taxable or deductible temporary differences} \times \text{Tax rates} = \text{Deferred tax liabilities or assets}$$

- Deferred tax assets also arise from unused tax losses that tax law allows to be carried forward, and are calculated in accordance with the following formula:

$$\text{Unused tax losses} \times \text{Tax rates} = \text{Deferred tax assets}$$

- The notion of temporary differences is central to understanding the requirements of this Standard. A taxable temporary difference gives rise to a deferred tax liability. A deductible temporary difference gives rise to a deferred tax asset. A taxable or deductible temporary difference arises when the carrying amount of an asset or a liability differs from its tax base. The meaning of "tax base" is of key importance to applying the requirements of this Standard. Tax base is defined in paragraph 5 of this Standard and is generally the amount that would be shown as an asset or a liability in a statement of financial position prepared for tax purposes. Unlike the practice in some other countries, it is not customary in Hong Kong for entities to prepare tax-based statements of financial position. However, the notion of a tax-based statement of financial position is relevant to this Standard and may be used as a basis for working papers developed for the purpose of implementing this Standard.
- This Standard generally requires an entity to recognise the tax consequences of transactions and other events consistently with the way that it recognises the transactions and other events themselves. Thus, for transactions and other events recognised in net profit or loss for the period, any related tax effects are also recognised in net profit or loss for the period. For transactions and other events that are recognised as direct credits to equity (direct debits to equity), any related tax effects are generally recognised as direct debits to equity (direct credits to equity).

## Scope

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- 1 **This Standard shall be applied in accounting for income taxes.**
- 2 For the purposes of this Standard, income taxes include all domestic and foreign taxes which are based on taxable profits. Income taxes also include taxes, such as withholding taxes, which are payable by a subsidiary, associate or joint arrangement on distributions to the reporting entity.
- 3 [Deleted]
- 4 This Standard does not deal with the methods of accounting for government grants (see HKAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*) or investment tax credits. However, this Standard does deal with the accounting for temporary differences that may arise from such grants or investment tax credits.

## Definitions

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- 5 **The following terms are used in this Standard with the meanings specified:**

*Accounting profit* is profit or loss for a period before deducting tax expense.

*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.

*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.

*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 either:*

- (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.**

- 6 Tax expense (tax income) comprises current tax expense (current tax income) and deferred tax expense (deferred tax income).

## **Tax Base**

*This section provides guidance for the calculation of tax base in different circumstances. The concept of tax base is of key importance in implementing the principles in this Standard. A difference between the carrying amount of an asset or a liability and the tax base of the asset or liability is a taxable temporary difference or a deductible temporary difference that gives rise to a deferred tax liability or asset, respectively.*

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

The tax base of an asset may be calculated as the asset's carrying amount, less any future taxable amounts plus any future deductible amounts that are expected to arise from recovering the asset's carrying amount as at the end of the reporting period. For example, in the case of plant and equipment, the tax base is the tax written down value.



**Examples**

**Examples of the calculation of the tax base of assets**

- 1 A machine cost \$100 and is expected to be ultimately disposed of for an amount that is equal to or less than cost. For tax purposes, depreciation of \$30 has already 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. Revenue generated by using the machine (that is, revenue generated from recovering the carrying amount of the machine) is taxable, any gain or loss on disposal will be subject to a balancing adjustment (such as for recouped depreciation) for tax purposes. The machine has been depreciated for accounting purposes by \$20.

The tax base of the machine is:

<i>Carrying Amount</i>	<i>Taxable Amounts</i>	<i>Deductible Amounts</i>		<i>Tax Base</i>
\$80	- \$80	+ \$70	=	\$70

- 2 Leasehold land with a cost of \$100 and a carrying amount of \$90 is revalued to \$150. For tax purposes, depreciation of \$20 has been deducted in the current and prior periods and the remaining cost will be deductible in future periods through depreciation. Revenue generated from the use of the leasehold land is taxable and any gain or loss on disposal will be subject to a balancing adjustment for tax purposes.

The tax base of the leasehold land is:

<i>Carrying Amount</i>	<i>Taxable Amounts</i>	<i>Deductible Amounts</i>		<i>Tax Base</i>
\$150	- \$150	+ \$80	=	\$80

- 3 Freehold land with a cost of \$100 is revalued to \$150. For tax purposes, there is no depreciation. Revenue generated from the use of the freehold land is taxable. However, any gain on disposal of the land at the revalued amount will not be taxable.

The tax base of the freehold land is:

<i>Carrying Amount</i>	<i>Taxable Amounts</i>	<i>Deductible Amounts</i>		<i>Tax Base</i>
\$150	- \$150	+ \$100	=	\$100

- 4 Trade receivables has a carrying amount of \$100 and is expected to be recovered through payments from debtors. There are no doubtful debts. The related revenue of \$100 has already been included in the calculation of taxable profit (tax loss).

The tax base of the trade receivables is:

<i>Carrying Amount</i>	<i>Taxable Amounts</i>	<i>Deductible Amounts</i>		<i>Tax Base</i>
\$100	- Nil	+ Nil	=	\$100

- 5 Trade receivables has a carrying amount of \$100, for which specific bad debt provisions amounting to \$20 have been made. These provisions have already been deducted for tax purposes.

The tax base of the trade receivables is:

<i>Carrying Amount</i>	<i>Taxable Amounts</i>	<i>Deductible Amounts</i>		<i>Tax Base</i>
\$100	- Nil	+ Nil	=	\$100

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- 6 Trade receivables has a carrying amount of \$100, for which general bad debt provisions amounting to \$20 have been made. These provisions have not yet been deducted for tax purposes but are expected to give rise to future deductible amounts.

The tax base of the trade receivables is:

<i>Carrying Amount</i>	<i>Taxable Amounts</i>		<i>Deductible Amounts</i>		<i>Tax Base</i>
\$100	- Nil	+	\$20	=	\$120

- 7 A loan receivable has a carrying amount of \$100 and is expected to be recovered through payments from the borrower. The repayment of the carrying amount of the loan as at the end of the reporting period will have no tax consequences.

The tax base of the loan is:

<i>Carrying Amount</i>	<i>Taxable Amounts</i>		<i>Deductible Amounts</i>		<i>Tax Base</i>
\$100	- Nil	+	Nil	=	\$100

- 8 Dividends receivable from a subsidiary have a carrying amount of \$100. The dividends are not taxable.

The tax base of the dividends receivable is:

<i>Carrying Amount</i>	<i>Taxable Amounts</i>		<i>Deductible Amounts</i>		<i>Tax Base*</i>
\$100	- Nil	+	Nil	=	\$100

- 9 An interest receivable has a carrying amount of \$100. The related interest revenue will be taxed only when received.

The tax base of the interest receivable is:

<i>Carrying Amount</i>	<i>Taxable Amounts</i>		<i>Deductible Amounts</i>		<i>Tax Base</i>
\$100	- \$100	+	Nil	=	Nil

\* Under this analysis, there is no taxable temporary difference. An alternative analysis is that the accrued dividends receivable have a tax base of nil and that a tax rate of nil is applied to the resulting taxable temporary difference of 100. Under both analyses, there is no deferred tax liability.

- 8 The tax base of a liability is its carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods. In the case of revenue which is received in advance, the tax base of the resulting liability is its carrying amount, less any amount of the revenue that will not be taxable in future periods.

The tax base of a liability may be calculated as the liability's carrying amount as at the end of the reporting period less any future deductible amounts, plus any future taxable amounts, that are expected to arise from settling the liability's carrying amount as at the end of the reporting period. The tax base of a liability that is in the nature of "revenue received in advance", however, is calculated as the liability's carrying amount less any amount of the "revenue received in advance" that has been included in taxable amounts in the current or a previous reporting period.

**Examples**

**Calculation of the tax base of liabilities**

- 1 Current liabilities include accrued wages with a carrying amount of \$100. The related expense has already been deducted for tax purposes on an accrued basis (that is, the wages were deducted for tax purposes in the same year in which they were recognised as an expense for accounting purposes).

The tax base of the accrued expenses is:

<i>Carrying Amount</i>		<i>Deductible Amounts</i>		<i>Taxable Amounts</i>		<i>Tax Base</i>
\$100	-	Nil	+	Nil	=	\$100

- 2 Current liabilities include accrued fines and penalties with a carrying amount of \$100. Fines and penalties are not deductible for tax purposes.

The tax base of the accrued fines and penalties is:

<i>Carrying Amount</i>		<i>Deductible Amounts</i>		<i>Taxable Amounts</i>		<i>Tax Base*</i>
\$100	-	Nil	+	Nil	=	\$100

- 3 A loan payable has a carrying amount of \$100. The repayment of the carrying amount of the loan as at the end of the reporting period will not give rise to taxable or deductible amounts.

The tax base of the loan is:

<i>Carrying Amount</i>		<i>Deductible Amounts</i>		<i>Taxable Amounts</i>		<i>Tax Base</i>
\$100	-	Nil	+	Nil	=	\$100

- 4 Current liabilities include interest revenue received in advance, with a carrying amount of \$100. The related interest revenue was taxed on a cash basis.

The tax base of the interest received in advance is:

<i>Carrying Amount</i>		<i>Amount of revenue received in advance that has increased taxable amount (or decreased tax loss)</i>		<i>Tax Base</i>
\$100	-	\$100	=	Nil

- 5 A foreign currency loan payable has a carrying amount on initial recognition of \$100. Subsequently, the carrying amount is reduced to \$90 to reflect the change in exchange rates (an unrealised foreign exchange gain). Exchange gains are only taxable when they are realised. The repayment of the \$90 carrying amount of the loan will give rise to taxable amounts of \$10.

The tax base of the loan is:

<i>Carrying Amount</i>		<i>Deductible Amounts</i>		<i>Taxable Amounts</i>		<i>Tax Base</i>
\$90	-	Nil	+	\$10	=	\$100

\* Under this analysis, there is no deductible temporary difference. An alternative analysis is that the accrued fines and penalties payable have a tax base of nil and that a tax rate of nil is applied to the resulting deductible temporary difference of 100. Under both analyses, there is no deferred tax asset.

- 6 An interest payable has a carrying amount of \$100. The related interest will be deductible for tax purposes only when it is paid.

The tax base of the interest payable is:

<i>Carrying Amount</i>		<i>Deductible Amounts</i>		<i>Taxable Amounts</i>		<i>Tax Base</i>
\$100	-	\$100	+	Nil	=	Nil

- 9 Some items have a tax base but are not recognised as assets and liabilities in the statement of financial position. For example, research costs are recognised as an expense in determining accounting profit in the period in which they are incurred but may not be permitted as a deduction in determining taxable profit (tax loss) until a later period. The difference between the tax base of the research costs, being the amount the taxation authorities will permit as a deduction in future periods, and the carrying amount of nil is a deductible temporary difference that results in a deferred tax asset.
- 10 Where the tax base of an asset or liability is not immediately apparent, it is helpful to consider the fundamental principle upon which this Standard is based: that an entity shall, with certain limited exceptions, recognise a deferred tax liability (asset) whenever recovery or settlement of the carrying amount of an asset or liability would make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences. Example C following paragraph 51A illustrates circumstances when it may be helpful to consider this fundamental principle, for example, when the tax base of an asset or liability depends on the expected manner of recovery or settlement.
- 11 In consolidated financial statements, temporary differences are determined by comparing the carrying amounts of assets and liabilities in the consolidated financial statements with the appropriate tax base. The tax base is determined by reference to a consolidated tax return in those jurisdictions in which such a return is filed. In other jurisdictions, the tax base is determined by reference to the tax returns of each entity in the group.

## **Recognition of current tax liabilities and current tax assets**

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- 12 **Current tax for current and prior periods shall, to the extent unpaid, be recognised as a liability. If the amount already paid in respect of current and prior periods exceeds the amount due for those periods, the excess shall be recognised as an asset.**
- 13 **The benefit relating to a tax loss that can be carried back to recover current tax of a previous period shall be recognised as an asset.**
- 14 When a tax loss is used to recover current tax of 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.

## **Recognition of deferred tax liabilities and deferred tax assets**

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### **Taxable temporary differences**

- 15 **A deferred tax liability shall be recognised for all taxable temporary differences, except to the extent that the deferred tax liability arises from:**

- (a) the initial recognition of goodwill; or
- (b) the initial recognition of an asset or liability in a transaction which:
  - (i) is not a business combination; and
  - (ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

**However, for taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, a deferred tax liability shall be recognised in accordance with paragraph 39.**

16 It is inherent in the recognition of an asset that its carrying amount will be recovered in the form of economic benefits that flow to the entity in future periods. When the carrying amount of the asset exceeds its tax base, the amount of taxable economic benefits will exceed the amount that will be allowed as a deduction for tax purposes. This difference is a taxable temporary difference and the obligation to pay the resulting income taxes in future periods is a deferred tax liability. As the entity recovers the carrying amount of the asset, the taxable temporary difference will reverse and the entity will have taxable profit. This makes it probable that economic benefits will flow from the entity in the form of tax payments. Therefore, this Standard requires the recognition of all deferred tax liabilities, except in certain circumstances described in paragraphs 15 and 39.

The recovery of the carrying amount of many assets gives rise to taxable and deductible amounts. For example, an item of equipment may be used to produce goods that are in turn used to generate revenue, and therefore taxable amounts, and give rise to depreciation that is a deductible amount. When the carrying amount of the asset (equipment) exceeds its tax base, the amount of taxable economic benefits (taxable amounts) will exceed the amount that will be allowed as a deduction for tax purposes. This difference is a taxable temporary difference and the obligation to settle the resulting income taxes in future periods is a deferred tax liability. The example below illustrates a circumstance in which a deferred tax liability arises that is required to be recognised by this.

**Example**

**An example of circumstances that give rise to a deferred tax liability that is required to be recognised**

An asset that costs \$150 has a carrying amount of \$100. Cumulative depreciation for tax purposes is \$90 and the tax rate is 30%.

	Carrying Amount	Tax Base	Temporary Difference
	\$	\$	\$
At acquisition	150	150	
Accumulated Depreciation	50	90	
	———	———	
Net amount	100	60	40
Tax rate			30%
			———
Deferred Tax Liability			12

*The tax base of the asset is \$60 (cost of \$150 less cumulative tax depreciation of \$90). In recovering the carrying amount of \$100, the entity will derive taxable amounts of \$100, but will only be able to deduct tax depreciation of \$60. Consequently, the entity will pay income taxes of \$12 (calculated as \$40 x 30%) as a result of recovering the carrying amount of the asset. The difference between the carrying amount of \$100 and the tax base of \$60 is a taxable temporary difference of \$40. Therefore, the entity recognises a deferred tax liability of \$12 (calculated as \$40 x 30%) representing the effect on income tax payable as a consequence of recovering the carrying amount of the asset.*

17 Some temporary differences arise when income or expense is included in accounting profit in one period but is included in taxable profit in a different period. Such temporary differences are often described as timing differences. The following are examples of temporary differences of this kind which are taxable temporary differences and which therefore result in deferred tax liabilities:

- (a) interest revenue is included in accounting profit on a time proportion basis but may, in some jurisdictions, be included in taxable profit when cash is collected. The tax base of any receivable recognised in the statement of financial position with respect to such revenues is nil because the revenues do not affect taxable profit until cash is collected;
- (b) depreciation used in determining taxable profit (tax loss) may differ from that used in determining accounting profit. The temporary difference is the difference between the carrying amount of the asset and its tax base which is the original cost of the asset less all deductions in respect of that asset permitted by the taxation authorities in determining taxable profit of the current and prior periods. A taxable temporary difference arises, and results in a deferred tax liability, when tax depreciation is accelerated (if tax depreciation is less rapid than accounting depreciation, a deductible temporary difference arises and results in a deferred tax asset); and
- (c) development costs may be capitalised and amortised over future periods in determining accounting profit but deducted in determining taxable profit in the period in which they are incurred. Such development costs have a tax base of nil as they have already been deducted from taxable profit. The temporary difference is the difference between the carrying amount of the development costs and their tax base of nil.

18 Temporary differences also arise when:

- (a) the identifiable assets acquired and liabilities assumed in a business combination are recognised at their fair values in accordance with HKFRS 3 *Business Combinations*, but no equivalent adjustment is made for tax purposes (see paragraph 19);
- (b) assets are revalued and no equivalent adjustment is made for tax purposes (see paragraph 20);
- (c) goodwill arises in a business combination (see paragraph 21);
- (d) the tax base of an asset or liability on initial recognition differs from its initial carrying amount, for example when an entity benefits from non-taxable government grants related to assets (see paragraphs 22 and 33); or
- (e) the carrying amount of investments in subsidiaries, branches and associates or interests in joint arrangements becomes different from the tax base of the investment or interest (see paragraphs 38 - 45).

### **Business combinations**

19 With limited exceptions, the identifiable assets acquired and liabilities assumed in a business combination are recognised at their fair values at the acquisition date. Temporary differences arise when the tax bases of the identifiable assets acquired and liabilities assumed are not affected by the business combination or are affected differently. For example, when the carrying amount of an asset is increased to fair value but the tax base of the asset remains at cost to the previous owner, a taxable temporary difference arises which results in a deferred tax liability. The resulting deferred tax liability affects goodwill (see paragraph 66).

## Assets carried at fair value

- 20 HKFRSs permit or require certain assets to be carried at fair value or to be revalued (see, for example, HKAS 16 *Property, Plant and Equipment*, HKAS 38 *Intangible Assets*, HKAS 40 *Investment Property*, HKFRS 9 *Financial Instruments* and HKFRS 16 *Leases*). In some jurisdictions, the revaluation or other restatement of an asset to fair value affects taxable profit (tax loss) for the current period. As a result, the tax base of the asset is adjusted and no temporary difference arises. In other jurisdictions, the revaluation or restatement of an asset does not affect taxable profit in the period of the revaluation or restatement and, consequently, the tax base of the asset is not adjusted. Nevertheless, the future recovery of the carrying amount will result in a taxable flow of economic benefits to the entity and the amount that will be deductible for tax purposes will differ from the amount of those economic benefits. The difference between the carrying amount of a revalued asset and its tax base is a temporary difference and gives rise to a deferred tax liability or asset. This is true even if:
- (a) the entity does not intend to dispose of the asset. In such cases, the revalued carrying amount of the asset will be recovered through use and this will generate taxable income which exceeds the depreciation that will be allowable for tax purposes in future periods; or
  - (b) tax on capital gains is deferred if the proceeds of the disposal of the asset are invested in similar assets. In such cases, the tax will ultimately become payable on sale or use of the similar assets.

## Goodwill

- 21 Goodwill arising in a business combination is measured as the excess of (a) over (b) below:
- (a) the aggregate of:
    - (i) the consideration transferred measured in accordance with HKFRS 3, which generally requires acquisition-date fair value;
    - (ii) the amount of any non-controlling interest in the acquiree recognised in accordance with HKFRS 3; and
    - (iii) in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.
  - (b) the net of the acquisition-date amounts of the identifiable assets acquired and liabilities assumed measured in accordance with HKFRS 3.

Many taxation 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 base of nil. Any difference between the carrying amount of goodwill and its tax base of nil is a taxable temporary difference. However, this Standard does not permit the recognition of the resulting deferred tax liability because goodwill is measured as a residual and the recognition of the deferred tax liability would increase the carrying amount of goodwill.

- 21A 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 under paragraph 15(a).

For example, if in a business combination an entity recognises goodwill of CU100 that has a tax base of nil, paragraph 15(a) prohibits the entity from recognising the resulting deferred tax liability. If the entity subsequently recognises an impairment loss of CU20 for that goodwill, the amount of the taxable temporary difference relating to the goodwill is reduced from CU100 to CU80, 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 and is therefore prohibited from being recognised under paragraph 15(a).

- 21B Deferred tax liabilities for taxable temporary differences relating to goodwill are, however, recognised to the extent they do not arise from the initial recognition of goodwill. For example, if in a business combination an entity recognises goodwill of CU100 that is deductible for tax purposes at a rate of 20 per cent per year starting in the year of acquisition, the tax base of the goodwill is CU100 on initial recognition and CU80 at the end of the year of acquisition. If the carrying amount of goodwill at the end of the year of acquisition remains unchanged at CU100, a taxable temporary difference of CU20 arises at the end of that year. Because that taxable temporary difference does not relate to the initial recognition of the goodwill, the resulting deferred tax liability is recognised.

### **Initial recognition of an asset or liability**

- 22 A temporary difference may arise on 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. The method of accounting for such a temporary difference depends on the nature of the transaction that led to the initial recognition of the asset or liability:
- (a) in a business combination, an entity recognises any deferred tax liability or asset and this affects the amount of goodwill or bargain purchase gain it recognises (see paragraph 19);
  - (b) if the transaction affects either accounting profit or taxable profit, an entity recognises any deferred tax liability or asset and recognises the resulting deferred tax expense or income in profit or loss (see paragraph 59);
  - (c) if the transaction is not a business combination, and affects neither accounting profit nor taxable profit, an entity would, in the absence of the exemption provided by paragraphs 15 and 24, recognise the resulting deferred tax liability or asset and adjust the carrying amount of the asset or liability by the same amount. Such adjustments would make the financial statements less transparent. Therefore, this Standard does not permit an entity to recognise the resulting deferred tax liability or asset, either on initial recognition or subsequently (see example below). Furthermore, an entity does not recognise subsequent changes in the unrecognised deferred tax liability or asset as the asset is depreciated.



**Example illustrating paragraph 22(c)**

An entity intends to use an asset which cost \$1,000 throughout its useful life of five years and then dispose of it for a residual value of nil. The tax rate is 40%. Depreciation of the asset is not deductible for tax purposes. On disposal, any capital gain would not be taxable and any capital loss would not be deductible.

*As it recovers the carrying amount of the asset, the entity will earn taxable income of \$1,000 and pay tax of \$400. The entity does not recognise the resulting deferred tax liability of \$400 because it results from the initial recognition of the asset.*

*In the following year, the carrying amount of the asset is \$800. In earning taxable income of \$800, the entity will pay tax of \$320. The entity does not recognise the deferred tax liability of \$320 because it results from the initial recognition of the asset.*

- 23 In accordance with HKAS 32 *Financial Instruments: Presentation* the issuer of a compound financial instrument (for example, a convertible bond) classifies the instrument's liability component as a liability and the equity component as equity. In some jurisdictions, the tax base of the liability component on initial recognition is equal to the initial carrying amount of the sum of the liability and equity components. The resulting taxable temporary difference arises from the initial recognition of the equity component separately from the liability component. Therefore, the exception set out in paragraph 15(b) does not apply. Consequently, an entity recognises the resulting deferred tax liability. In accordance with paragraph 61A, the deferred tax is charged directly to the carrying amount of the equity component. In accordance with paragraph 58, subsequent changes in the deferred tax liability are recognised in profit or loss as deferred tax expense (income).

### **Deductible temporary differences**

- 24 **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, unless the deferred tax asset arises from the initial recognition of an asset or liability in a transaction that:**
- (a) **is not a business combination; and**
  - (b) **at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).**

**However, for deductible temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, a deferred tax asset shall be recognised in accordance with paragraph 44.**

- 25 It is inherent in the recognition of a liability that the carrying amount will be settled in future periods through an outflow from the entity of resources embodying economic benefits. When resources flow from the entity, part or all of their amounts may be deductible in determining taxable profit of a period later than the period in which the liability is recognised. In such cases, a temporary difference exists between the carrying amount of the liability and its tax base. Accordingly, a deferred tax asset arises in respect of the income taxes that will be recoverable in the future periods when that part of the liability is allowed as a deduction in determining taxable profit. Similarly, if the carrying amount of an asset is less than its tax base, the difference gives rise to a deferred tax asset in respect of the income taxes that will be recoverable in future periods.

Provisions such as guarantees, product warranties or employee entitlements (including long service payments) made for accounting purposes on an estimated basis may be deducted in determining accounting profit in the reporting period in which the liability for such items arises, but deducted in determining taxable profit when paid. The example below illustrates a circumstance in which a deferred tax asset arises.

**Example**

**An example of circumstances that give rise to a deferred tax asset**

An entity recognises a liability of \$100 for accrued product warranty costs. For tax purposes, the product warranty costs will not be deductible until the entity meets claims. The tax rate is 30%.

	Carrying Amount	Tax Base	Temporary Difference
	\$	\$	\$
Accrued Warranty Costs	100	Nil	100
Tax rate			30%
Deferred Tax Asset			30

*The tax base of the liability is nil (carrying amount of \$100, less the deductible amount of \$100 in respect of that liability in future periods). In settling the liability for its carrying amount, the entity will reduce its future taxable amount by \$100 and, consequently, reduce its future tax payments by \$30 (calculated as \$100 x 30%). The difference between the carrying amount of \$100 and the tax base of nil is a deductible temporary difference of \$100. Therefore, the entity recognises a deferred tax asset of \$30 (calculated as \$100 x 30%), provided that it is probable that the entity will earn sufficient taxable amounts in future periods to benefit from a reduction in tax payments.*

26 The following are examples of deductible temporary differences that result in deferred tax assets:

- (a) retirement benefit costs may be deducted in determining accounting profit as service is provided by the employee, but deducted in determining taxable profit either when contributions are paid to a fund by the entity or when retirement benefits are paid by the entity. A temporary difference exists between the carrying amount of the liability and its tax base; the tax base of the liability is usually nil. Such a deductible temporary difference results in a deferred tax asset as economic benefits will flow to the entity in the form of a deduction from taxable profits when contributions or retirement benefits are paid;
- (b) research costs are recognised as an expense in determining accounting profit in the period in which they are incurred but may not be permitted as a deduction in determining taxable profit (tax loss) until a later period. The difference between the tax base of the research costs, being the amount the taxation authorities will permit as a deduction in future periods, and the carrying amount of nil is a deductible temporary difference that results in a deferred tax asset;
- (c) with limited exceptions, an entity recognises the identifiable assets acquired and liabilities assumed in a business combination at their fair values at the acquisition date. When a liability assumed is recognised at the acquisition date but the related costs are not deducted in determining taxable profits until a later period, a deductible temporary difference arises which results in a deferred tax asset. A deferred tax asset also arises when the fair value of an identifiable asset acquired is less than its tax base. In both cases, the resulting deferred tax asset affects goodwill (see paragraph 66); and
- (d) certain assets may be carried at fair value, or may be revalued, without an equivalent adjustment being made for tax purposes (see paragraph 20). A

deductible temporary difference arises if the tax base of the asset exceeds its carrying amount.

**Example illustrating paragraph 26(d)**

Identification of a deductible temporary difference at the end of Year 2:

Entity A purchases for \$1,000, at the beginning of Year 1, a debt instrument with a nominal value of \$1,000 payable on maturity in 5 years with an interest rate of 2% payable at the end of each year. The effective interest rate is 2%. The debt instrument is measured at fair value.

At the end of Year 2, the fair value of the debt instrument has decreased to \$918 as a result of an increase in market interest rates to 5%. It is probable that Entity A will collect all the contractual cash flows if it continues to hold the debt instrument.

Any gains (losses) on the debt instrument are taxable (deductible) only when realised. The gains (losses) arising on the sale or maturity of the debt instrument are calculated for tax purposes as the difference between the amount collected and the original cost of the debt instrument.

Accordingly, the tax base of the debt instrument is its original cost.

*The difference between the carrying amount of the debt instrument in Entity A's statement of financial position of \$918 and its tax base of \$1,000 gives rise to a deductible temporary difference of \$82 at the end of Year 2 (see paragraphs 20 and 26(d)), irrespective of whether Entity A expects to recover the carrying amount of the debt instrument by sale or by use, ie by holding it and collecting contractual cash flows, or a combination of both.*

*This is because deductible temporary differences are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base 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 (see paragraph 5). Entity A obtains a deduction equivalent to the tax base of the asset of \$1,000 in determining taxable profit (tax loss) either on sale or on maturity.*

27 The reversal of deductible temporary differences results in deductions in determining taxable profits of future periods. However, economic benefits in the form of reductions in tax payments will flow to the entity only if it earns sufficient taxable profits against which the deductions can be offset. Therefore, an entity recognises deferred tax assets only when it is probable that taxable profits will be available against which the deductible temporary differences can be utilised.

27A When an entity assesses whether taxable profits will be available against which it can utilise a deductible temporary difference, it considers whether tax law restricts the sources of taxable profits against which it may make deductions on the reversal of that deductible temporary difference. If tax law imposes no such restrictions, an entity assesses a deductible temporary difference in combination with all of its other deductible differences. However, if tax law restricts the utilisation of losses to deduction against income of a specific type, a deductible temporary difference is assessed in combination only with other deductible temporary differences of the appropriate type.

28 It is probable that taxable profit will be available against which a deductible temporary difference can be utilised when there are sufficient taxable temporary differences relating to the same taxation authority and the same taxable entity which are expected to reverse:

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

In such circumstances, the deferred tax asset is recognised in the period in which the deductible temporary differences arise.

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

- (a) it is probable that the entity will have sufficient taxable profit relating to the same taxation authority and the same taxable entity in the same period as the reversal of the deductible temporary difference (or in the periods into which a tax loss arising from the deferred tax asset can be carried back or forward). In evaluating whether it will have sufficient taxable profit in future periods, an entity:
  - (i) compares the deductible temporary differences with future taxable profit that excludes tax deductions resulting from the reversal of those deductible temporary differences. This comparison shows the extent to which the future taxable profit is sufficient for the entity to deduct the amounts resulting from the reversal of those deductible temporary differences; and
  - (ii) ignores taxable amounts arising from deductible temporary differences that are expected to originate in future periods, because the deferred tax asset arising from these deductible temporary differences will itself require future taxable profit in order to be utilised; or
- (b) tax planning opportunities are available to the entity that will create taxable profit in appropriate periods.

29A The estimate of probable future taxable profit may include the recovery of some of an entity's assets for more than their carrying amount if there is sufficient evidence that it

is probable that the entity will achieve this. For example, when an asset is measured at fair value, the entity shall consider whether there is sufficient evidence to conclude that it is probable that the entity will recover the asset for more than its carrying amount. This may be the case, for example, when an entity expects to hold a fixed-rate debt instrument and collect the contractual cash flows.

**Example illustrating paragraph 29(a)**

An entity has a tax loss of \$1000 which can be carried forward for 5 years. The estimated cumulative taxable profits for the next five years are \$600. It is estimated that \$400 of the tax loss will expire unused. The tax rate is 30%.

*The entity recognises a deferred tax asset of \$180 (\$600 x 30%)*

Suppose the entity expects to buy a machine that costs \$300 with a useful life for accounting purposes of 2 years, and a useful life for the purpose of calculating tax depreciation of 3 years. In year 1, a deductible temporary difference of \$50 (representing the tax base of \$200 less the carrying amount of \$150) will arise corresponding to taxable income of \$50 and a further deductible amount (and taxable income) of \$50 will arise in year 2. These differences will reverse (with a reduction of \$100 in taxable profit) in year 3.

*The entity ignores the taxable income of \$50 in years 1 and 2 when evaluating whether there is sufficient taxable profit to utilise the tax loss carried forward. This is because it merely creates another deductible temporary difference, which itself needs to be tested for recoverability.*

30 Tax planning opportunities are actions that the entity would take in order to create or increase taxable income in a particular period before the expiry of a tax loss or tax credit carryforward. For example, in some jurisdictions, taxable profit may be created or increased by:

- (a) electing to have interest income taxed on either a received or receivable basis;
- (b) deferring the claim for certain deductions from taxable profit;
- (c) selling, and perhaps leasing back, assets that have appreciated but for which the tax base has not been adjusted to reflect such appreciation; and
- (d) selling an asset that generates non-taxable income (such as, in some jurisdictions, a government bond) in order to purchase another investment that generates taxable income.

Where tax planning opportunities advance taxable profit from a later period to an earlier period, the utilisation of a tax loss or tax credit carryforward still depends on the existence of future taxable profit from sources other than future originating temporary differences.

31 When an entity has a history of recent losses, the entity considers the guidance in paragraphs 35 and 36.

32 [Deleted]

## Goodwill

32A If the carrying amount of goodwill arising in a business combination is less than its tax base, the difference gives rise to a deferred tax asset. The deferred tax asset arising from the initial recognition of goodwill shall be recognised as part of the accounting for a business combination to the extent that it is probable that taxable profit will be available against which the deductible temporary difference could be utilised.

## Initial recognition of an asset or liability

- 33 One case when a deferred tax asset arises on initial recognition of an asset is when a non-taxable government grant related to an asset is deducted in arriving at the carrying amount of the asset but, for tax purposes, is not deducted from the asset's depreciable amount (in other words its tax base); the carrying amount of the asset is less than its tax base and this gives rise to a deductible temporary difference. Government grants may also be set up as deferred income in which case the difference between the deferred income and its tax base of nil is a deductible temporary difference. Whichever method of presentation an entity adopts, the entity does not recognise the resulting deferred tax asset, for the reason given in paragraph 22.

## Unused tax losses and unused tax credits

- 34 **A deferred tax asset shall be recognised for the carryforward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised.**

- 35 The criteria for recognising deferred tax assets arising from the carryforward of unused tax losses and tax credits are the same as the criteria for recognising deferred tax assets arising from deductible temporary differences. However, the existence of unused tax losses is strong evidence that future taxable profit may not be available. Therefore, when an entity has a history of recent losses, the entity recognises a deferred tax asset arising from unused tax losses or tax credits only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilised by the entity. In such circumstances, paragraph 82 requires disclosure of the amount of the deferred tax asset and the nature of the evidence supporting its recognition.

- 36 An entity considers the following criteria in assessing the probability that taxable profit will be available against which the unused tax losses or unused tax credits can be utilised:

- (a) whether the entity has sufficient taxable temporary differences relating to the same taxation authority and the same taxable entity, which will result in taxable amounts against which the unused tax losses or unused tax credits can be utilised before they expire;
- (b) whether it is probable that the entity will have taxable profits before the unused tax losses or unused tax credits expire;
- (c) whether the unused tax losses result from identifiable causes which are unlikely to recur; and
- (d) whether tax planning opportunities (see paragraph 30) are available to the entity that will create taxable profit in the period in which the unused tax losses or unused tax credits can be utilised.

To the extent that it is not probable that taxable profit will be available against which the unused tax losses or unused tax credits can be utilised, the deferred tax asset is not recognised.

## Reassessment of unrecognised deferred tax assets

- 37 At the end of each reporting period, an entity reassesses unrecognised deferred tax assets. The entity recognises a previously unrecognised deferred tax asset to the

extent that it has become probable that future taxable profit will allow the deferred tax asset to be recovered. For example, an improvement in trading conditions may make it more probable that the entity will be able to generate sufficient taxable profit in the future for the deferred tax asset to meet the recognition criteria set out in paragraph 24 or 34. Another example is when an entity reassesses deferred tax assets at the date of a business combination or subsequently (see paragraphs 67 and 68).

## **Investments in subsidiaries, branches and associates and interests in joint arrangements**

38 Temporary differences arise when the carrying amount of investments in subsidiaries, branches and associates or interests in joint arrangements (namely the parent or investor's share of the net assets of the subsidiary, branch, associate or investee, including the carrying amount of goodwill) becomes different from the tax base (which is often cost) of the investment or interest. Such differences may arise in a number of different circumstances, for example:

- (a) the existence of undistributed profits of subsidiaries, branches, associates and joint arrangements;
- (b) changes in foreign exchange rates when a parent and its subsidiary are based in different countries; and
- (c) a reduction in the carrying amount of an investment in an associate to its recoverable amount.

In consolidated financial statements, the temporary difference may be different from the temporary difference associated with that investment in the parent's separate financial statements if the parent carries the investment in its separate financial statements at cost or revalued amount.

39 **An entity shall recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, except to the extent that both of the following conditions are satisfied:**

- (a) **the parent, investor, joint venturer or joint operator is able to control the timing of the reversal of the temporary difference; and**
- (b) **it is probable that the temporary difference will not reverse in the foreseeable future.**

40 As a parent controls the dividend policy of its subsidiary, it is able to control the timing of the reversal of temporary differences associated with that investment (including the temporary differences arising not only from undistributed profits but also from any foreign exchange translation differences). Furthermore, it would often be impracticable to determine the amount of income taxes that would be payable when the temporary difference reverses. Therefore, when the parent has determined that those profits will not be distributed in the foreseeable future the parent does not recognise a deferred tax liability. The same considerations apply to investments in branches.

41 The non-monetary assets and liabilities of an entity are measured in its functional currency (see HKAS 21 *The Effects of Changes in Foreign Exchange Rates*). If the entity's taxable profit or tax loss (and, hence, the tax base of its non-monetary assets and liabilities) is determined in a different currency, changes in the exchange rate give rise to temporary differences that result in a recognised deferred tax liability or (subject to paragraph 24) asset. The resulting deferred tax is charged or credited to profit or loss (see paragraph 58).

- 42 An investor in an associate does not control that entity and is usually not in a position to determine its dividend policy. Therefore, in the absence of an agreement requiring that the profits of the associate will not be distributed in the foreseeable future, an investor recognises a deferred tax liability arising from taxable temporary differences associated with its investment in the associate. In some cases, an investor may not be able to determine the amount of tax that would be payable if it recovers the cost of its investment in an associate, but can determine that it will equal or exceed a minimum amount. In such cases, the deferred tax liability is measured at this amount.
- 43 The arrangement between the parties to a joint arrangement usually deals with the distribution of the profits and identifies whether decisions on such matters require the consent of all the parties or a group of the parties. When the joint venturer or joint operator can control the timing of the distribution of its share of the profits of the joint arrangement and it is probable that its share of the profits will not be distributed in the foreseeable future, a deferred tax liability is not recognised.
- 44 **An entity shall recognise a deferred tax asset for all deductible temporary differences arising from investments in subsidiaries, branches and associates, and interests in joint arrangements, to the extent that, and only to the extent that, it is probable that:**
- (a) **the temporary difference will reverse in the foreseeable future; and**
  - (b) **taxable profit will be available against which the temporary difference can be utilised.**
- 45 In deciding whether a deferred tax asset is recognised for deductible temporary differences associated with its investments in subsidiaries, branches and associates, and its interests in joint arrangements, an entity considers the guidance set out in paragraphs 28 to 31.

## Measurement

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- 46 **Current tax liabilities (assets) for the current and prior periods shall be measured at the amount expected to be paid to (recovered from) the taxation authorities, using the tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.**
- 47 **Deferred tax assets and liabilities shall be measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.**
- 48 Current and deferred tax assets and liabilities are usually measured using the tax rates (and tax laws) that have been enacted. However, in some jurisdictions, announcements of tax rates (and tax laws) by the government have the substantive effect of actual enactment, which may follow the announcement by a period of several months. In these circumstances, tax assets and liabilities are measured using the announced tax rate (and tax laws).
- 49 When different tax rates apply to different levels of taxable income, deferred tax assets and liabilities are measured using the average rates that are expected to apply to the taxable profit (tax loss) of the periods in which the temporary differences are expected to reverse.
- 50 [Deleted]
- 51 **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 end of the reporting period, to recover or settle the carrying amount of its assets and liabilities.**

51A In some jurisdictions, the manner in which an entity recovers (settles) the carrying amount of an asset (liability) may affect either or both of:

- (a) the tax rate applicable when the entity recovers (settles) the carrying amount of the asset (liability); and
- (b) the tax base of the asset (liability).

In such cases, an entity measures deferred tax liabilities and deferred tax assets using the tax rate and the tax base that are consistent with the expected manner of recovery or settlement.

<b>Example A</b>
<p>An item of property, plant and equipment has a carrying amount of 100 and a tax base of 60. A tax rate of 20% would apply if the item were sold and a tax rate of 30% would apply to other income.</p> <p><i>The entity recognises a deferred tax liability of 8 (40 at 20%) if it expects to sell the item without further use and a deferred tax liability of 12 (40 at 30%) if it expects to retain the item and recover its carrying amount through use.</i></p>

<b>Example B</b>																
<p>An item of property, plant and equipment with a cost of 100 and a carrying amount of 80 is revalued to 150. No equivalent adjustment is made for tax purposes. Cumulative depreciation for tax purposes is 30 and the tax rate is 30%. If the item is sold for more than cost, the cumulative tax depreciation of 30 will be included in taxable income but sale proceeds in excess of cost will not be taxable.</p> <p><i>The tax base of the item is 70 and there is a taxable temporary difference of 80. If the entity expects to recover the carrying amount by using the item, it must generate taxable income of 150, but will only be able to deduct depreciation of 70. On this basis, there is a deferred tax liability of 24 (80 at 30%). If the entity expects to recover the carrying amount by selling the item immediately for proceeds of 150, the deferred tax liability is computed as follows:</i></p>																
<table style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="width: 60%;"></th> <th style="text-align: center; width: 15%;">Taxable Temporary Difference</th> <th style="text-align: center; width: 15%;">Tax Rate</th> <th style="text-align: center; width: 10%;">Deferred Tax Liability</th> </tr> </thead> <tbody> <tr> <td>Cumulative tax depreciation</td> <td style="text-align: center;">30</td> <td style="text-align: center;">30%</td> <td style="text-align: center;">9</td> </tr> <tr> <td>Proceeds in excess of cost</td> <td style="text-align: center;">50</td> <td style="text-align: center;">nil</td> <td style="text-align: center;">–</td> </tr> <tr> <td><b>Total</b></td> <td style="text-align: center; border-top: 1px solid black; border-bottom: 3px double black;">80</td> <td></td> <td style="text-align: center; border-top: 1px solid black; border-bottom: 3px double black;">9</td> </tr> </tbody> </table>		Taxable Temporary Difference	Tax Rate	Deferred Tax Liability	Cumulative tax depreciation	30	30%	9	Proceeds in excess of cost	50	nil	–	<b>Total</b>	80		9
	Taxable Temporary Difference	Tax Rate	Deferred Tax Liability													
Cumulative tax depreciation	30	30%	9													
Proceeds in excess of cost	50	nil	–													
<b>Total</b>	80		9													
<p><i>(note: in accordance with paragraph 61A, the additional deferred tax that arises on the revaluation is recognised in other comprehensive income)</i></p>																

**Example C**

The facts are as in example B, except that if the item is sold for more than cost, the cumulative tax depreciation will be included in taxable income (taxed at 30%) and the sale proceeds will be taxed at 40%, after deducting an inflation-adjusted cost of 110.

*If the entity expects to recover the carrying amount by using the item, it must generate taxable income of 150, but will only be able to deduct depreciation of 70. On this basis, the tax base is 70, there is a taxable temporary difference of 80 and there is a deferred tax liability of 24 (80 at 30%), as in example B.*

*If the entity expects to recover the carrying amount by selling the item immediately for proceeds of 150, the entity will be able to deduct the indexed cost of 110. The net proceeds of 40 will be taxed at 40%. In addition, the cumulative tax depreciation of 30 will be included in taxable income and taxed at 30%. On this basis, the tax base is 80 (110 less 30), there is a taxable temporary difference of 70 and there is a deferred tax liability of 25 (40 at 40% plus 30 at 30%). If the tax base is not immediately apparent in this example, it may be helpful to consider the fundamental principle set out in paragraph 10.*

*(note: in accordance with paragraph 61A, the additional deferred tax that arises on the revaluation is recognised in other comprehensive income)*

- 51B If a deferred tax liability or deferred tax asset arises from a non-depreciable asset measured using the revaluation model in HKAS 16, the measurement of the deferred tax liability or deferred tax asset shall reflect the tax consequences of recovering the carrying amount of the non-depreciable asset through sale, regardless of the basis of measuring the carrying amount of that asset. Accordingly, if the tax law specifies a tax rate applicable to the taxable amount derived from the sale of an asset that differs from the tax rate applicable to the taxable amount derived from using an asset, the former rate is applied in measuring the deferred tax liability or asset related to a non-depreciable asset.
- 51C If a deferred tax liability or asset arises from investment property that is measured using the fair value model in HKAS 40, there is a rebuttable presumption that the carrying amount of the investment property will be recovered through sale. Accordingly, unless the presumption is rebutted, the measurement of the deferred tax liability or deferred tax asset shall reflect the tax consequences of recovering the carrying amount of the investment property entirely through sale. This presumption is rebutted if the investment property is depreciable and is held within a business model whose objective is to consume substantially all of the economic benefits embodied in the investment property over time, rather than through sale. If the presumption is rebutted, the requirements of paragraphs 51 and 51A shall be followed.

**Example illustrating paragraph 51C**

An investment property has a cost of 100 and fair value of 150. It is measured using the fair value model in HKAS 40. It comprises land with a cost of 40 and fair value of 60 and a building with a cost of 60 and fair value of 90. The land has an unlimited useful life.

Cumulative depreciation of the building for tax purposes is 30. Unrealised changes in the fair value of the investment property do not affect taxable profit. If the investment property is sold for more than cost, the reversal of the cumulative tax depreciation of 30 will be included in taxable profit and taxed at an ordinary tax rate of 30%. For sales proceeds in excess of cost, tax law specifies tax rates of 25% for assets held for less than two years and 20% for assets held for two years or more.

*Because the investment property is measured using the fair value model in HKAS 40, there is a rebuttable presumption that the entity will recover the carrying amount of the investment property entirely through sale. If that presumption is not rebutted, the deferred tax reflects the tax consequences of recovering the carrying amount entirely through sale, even if the entity expects to earn rental income from the property before sale.*

INCOME TAXES

The tax base of the land if it is sold is 40 and there is a taxable temporary difference of 20 (60 – 40). The tax base of the building if it is sold is 30 (60 – 30) and there is a taxable temporary difference of 60 (90 – 30). As a result, the total taxable temporary difference relating to the investment property is 80 (20 + 60).

In accordance with paragraph 47, the tax rate is the rate expected to apply to the period when the investment property is realised. Thus, the resulting deferred tax liability is computed as follows, if the entity expects to sell the property after holding it for more than two years:

	Taxable Temporary Difference	Tax Rate	Deferred Tax Liability
Cumulative tax depreciation	30	30%	9
Proceeds in excess of cost	50	20%	10
Total	80		19

If the entity expects to sell the property after holding it for less than two years, the above computation would be amended to apply a tax rate of 25%, rather than 20%, to the proceeds in excess of cost.

If, instead, the entity holds the building within a business model whose objective is to consume substantially all of the economic benefits embodied in the building over time, rather than through sale, this presumption would be rebutted for the building. However, the land is not depreciable. Therefore the presumption of recovery through sale would not be rebutted for the land. It follows that the deferred tax liability would reflect the tax consequences of recovering the carrying amount of the building through use and the carrying amount of the land through sale.

The tax base of the building if it is used is 30 (60 – 30) and there is a taxable temporary difference of 60 (90 – 30), resulting in a deferred tax liability of 18 (60 at 30%).

The tax base of the land if it is sold is 40 and there is a taxable temporary difference of 20 (60 – 40), resulting in a deferred tax liability of 4 (20 at 20%).

As a result, if the presumption of recovery through sale is rebutted for the building, the deferred tax liability relating to the investment property is 22 (18 + 4).

- 51D The rebuttable presumption in paragraph 51C also applies when a deferred tax liability or a deferred tax asset arises from measuring investment property in a business combination if the entity will use the fair value model when subsequently measuring that investment property.
- 51E Paragraphs 51B–51D do not change the requirements to apply the principles in paragraphs 24–33 (deductible temporary differences) and paragraphs 34–36 (unused tax losses and unused tax credits) of this Standard when recognising and measuring deferred tax assets.
- 52 [moved and renumbered 51A]
- 52A In some jurisdictions, income taxes are payable at a higher or lower rate if part or all of the net profit or retained earnings is paid out as a dividend to shareholders of the entity. In some other jurisdictions, income taxes may be refundable or payable if part or all of the net profit or retained earnings is paid out as a dividend to shareholders of the entity. In these circumstances, current and deferred tax assets and liabilities are measured at the tax rate applicable to undistributed profits.
- 52B [Deleted]

**Example Illustrating Paragraphs 52A and 57A**

The following example deals with the measurement of current and deferred tax assets and liabilities for an entity in a jurisdiction where income taxes are payable at a higher rate on undistributed profits (50%) with an amount being refundable when profits are distributed. The tax rate on distributed profits is 35%. At the end of the reporting period, 31 December 20X1, the entity does not recognise a liability for dividends proposed or declared after the reporting period. As a result, no dividends are recognised in the year 20X1. Taxable income for 20X1 is 100,000. The net taxable temporary difference for the year 20X1 is 40,000.

*The entity recognises a current tax liability and a current income tax expense of 50,000 (100,000 at 50%). No asset is recognised for the amount potentially recoverable as a result of future dividends. The entity also recognises a deferred tax liability and deferred tax expense of 20,000 (40,000 at 50%) representing the income taxes that the entity will pay when it recovers or settles the carrying amounts of its assets and liabilities based on the tax rate applicable to undistributed profits.*

Subsequently, on 15 March 20X2 the entity recognises dividends of 10,000 from previous operating profits as a liability.

*On 15 March 20X2, the entity recognises the recovery of income taxes of 1,500 (15% of the dividends recognised as a liability) as a current tax asset and as a reduction of current income tax expense for 20X2.*

- 53 Deferred tax assets and liabilities shall not be discounted.**
- 54 The reliable determination of deferred tax assets and liabilities on a discounted basis requires detailed scheduling of the timing of the reversal of each temporary difference. In many cases such scheduling is impracticable or highly complex. Therefore, it is inappropriate to require discounting of deferred tax assets and liabilities. To permit, but not to require, discounting would result in deferred tax assets and liabilities which would not be comparable between entities. Therefore, this Standard does not require or permit the discounting of deferred tax assets and liabilities.
- 55 Temporary differences are determined by reference to the carrying amount of an asset or liability. This applies even where that carrying amount is itself determined on a discounted basis, for example in the case of retirement benefit obligations (see HKAS19 *Employee Benefits*).
- 56 The carrying amount of a deferred tax asset shall be reviewed at the end of each reporting period. An entity shall reduce the carrying amount of a deferred tax asset to the extent that it is no longer probable that sufficient taxable profit will be available to allow the benefit of part or all of that deferred tax asset to be utilised. Any such reduction shall be reversed to the extent that it becomes probable that sufficient taxable profit will be available.**

## Recognition of current and deferred tax

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57 Accounting for the current and deferred tax effects of a transaction or other event is consistent with the accounting for the transaction or event itself. Paragraphs 58 to 68C implement this principle.

57A An entity shall recognise the income tax consequences of dividends as defined in HKFRS 9 when it recognises a liability to pay a dividend. The income tax consequences of dividends are linked more directly to past transactions or events that generated distributable profits than to distributions to owners. Therefore, an entity shall recognise the income tax consequences of dividends in profit or loss, other comprehensive income or equity according to where the entity originally recognised those past transactions or events.

### Items recognised in profit or loss

58 **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) **a transaction or event which is recognised, in the same or a different period, outside profit or loss, either in other comprehensive income or directly in equity (see paragraphs 61A - 65); or**
- (b) **a business combination (other than the acquisition by an investment entity, as defined in HKFRS 10 *Consolidated Financial Statements*, of a subsidiary that is required to be measured at fair value through profit or loss) (see paragraphs 66 - 68).**

59 Most deferred tax liabilities and deferred tax assets arise where income or expense is included in accounting profit in one period, but is included in taxable profit (tax loss) in a different period. The resulting deferred tax is recognised in profit or loss. Examples are when:

- (a) interest, royalty or dividend revenue is received in arrears and is included in accounting profit in accordance with HKFRS 15 *Revenue from Contracts with Customers*, HKAS 39 *Financial Instruments: Recognition and Measurement* or HKFRS 9 *Financial Instruments*, as relevant, but is included in taxable profit (tax loss) on a cash basis; and
- (b) costs of intangible assets have been capitalised in accordance with HKAS 38, and are being amortised in profit or loss, but were deducted for tax purposes when they were incurred.

60 The carrying amount of deferred tax assets and liabilities may change even though there is no change in the amount of the related temporary differences. This can result, for example, from:

- (a) a change in tax rates or tax laws;
- (b) a reassessment of the recoverability of deferred tax assets; or
- (c) a change in the expected manner of recovery of an asset.

The resulting deferred tax is recognised in profit or loss, except to the extent that it relates to items previously recognised outside profit or loss (see paragraph 63).

## Items recognised outside profit or loss

- 61 [Deleted]
- 61A **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 relates to items that are recognised, in the same or a different period:**
- (a) **in other comprehensive income, shall be recognised in other comprehensive income (see paragraph 62).**
  - (b) **directly in equity, shall be recognised directly in equity (see paragraph 2A).**
- 62 Hong Kong Financial Reporting Standards require or permit particular items to be recognised in other comprehensive income. Examples of such items are:
- (a) a change in carrying amount arising from the revaluation of property, plant and equipment (see HKAS 16); and
  - (b) [deleted]
  - (c) exchange differences arising on the translation of the financial statements of a foreign operation (see HKAS 21).
  - (d) [deleted]
- 62A Hong Kong Financial Reporting Standards require or permit particular items to be credited or charged directly to equity. Examples of such items are:
- (a) an adjustment to the opening balance of retained earnings resulting from either a change in accounting policy that is applied retrospectively or the correction of an error (see HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*); and
  - (b) amounts arising on initial recognition of the equity component of a compound financial instrument (see paragraph 23).
- 63 In exceptional circumstances it may be difficult to determine the amount of current and deferred tax that relates to items recognised outside profit or loss (either in other comprehensive income or directly in equity). This may be the case, for example, when:
- (a) there are graduated rates of income tax and it is impossible to determine the rate at which a specific component of taxable profit (tax loss) has been taxed;
  - (b) a change in the tax rate or other tax rules affects a deferred tax asset or liability relating (in whole or in part) to an item that was previously recognised outside profit or loss; or
  - (c) an entity determines that a deferred tax asset should be recognised, or should no longer be recognised in full, and the deferred tax asset relates (in whole or in part) to an item that was previously recognised outside profit or loss.

In such cases, the current and deferred tax related to items that are recognised outside profit or loss are based on a reasonable pro rata allocation of the current and deferred tax of the entity in the tax jurisdiction concerned, or other method that achieves a more appropriate allocation in the circumstances.

- 64 HKAS 16 does not specify whether an entity should transfer each year from revaluation surplus to retained earnings an amount equal to the difference between the depreciation or amortisation on a revalued asset and the depreciation or amortisation based on the cost of that asset. If an entity makes such a transfer, the amount transferred is net of any related deferred tax. Similar considerations apply to transfers made on disposal of an item of property, plant or equipment.
- 65 When an asset is revalued for tax purposes and that revaluation is related to an accounting revaluation of an earlier period, or to one that is expected to be carried out in a future period, the tax effects of both the asset revaluation and the adjustment of the tax base are recognised in other comprehensive income in the periods in which they occur. However, if the revaluation for tax purposes is not related to an accounting revaluation of an earlier period, or to one that is expected to be carried out in a future period, the tax effects of the adjustment of the tax base are recognised in profit or loss.
- 65A 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. In many jurisdictions, this amount is referred to as a withholding tax. Such an amount paid or payable to taxation authorities is charged to equity as a part of the dividends.

### **Deferred tax arising from a business combination**

- 66 As explained in paragraphs 19 and 26(c), temporary differences may arise in a business combination. In accordance with HKFRS 3, an entity recognises any resulting deferred tax assets (to the extent that they meet the recognition criteria in paragraph 24) or deferred tax liabilities as identifiable assets and liabilities at the acquisition date. Consequently, those deferred tax assets and deferred tax liabilities affect the amount of goodwill or the bargain purchase gain the entity recognises. However, in accordance with paragraph 15(a), an entity does not recognise deferred tax liabilities arising from the initial recognition of goodwill.
- 67 As a result of a business combination, the probability of realising a pre-acquisition deferred tax asset of the acquirer could change. An acquirer may consider it probable that it will recover its own deferred tax asset that was not recognised before the business combination. For example, the acquirer may be able to utilise the benefit of its unused tax losses against the future taxable profit of the acquiree. Alternatively, as result of the business combination it might no longer be probable that future taxable profit will allow the deferred tax asset to be recovered. In such cases, the acquirer recognises a change in the deferred tax asset in the period of the business combination, but does not include it as part of the accounting for the business combination. Therefore, the acquirer does not take it into account in measuring the goodwill or bargain purchase gain it recognises in the business combination.
- 68 The potential benefit of the acquiree's income tax loss carryforwards or other deferred tax assets might not satisfy the criteria for separate recognition when a business combination is initially accounted for but might be realised subsequently. An entity shall recognise acquired deferred tax benefits that it realises after the business combination as follows:
- (a) Acquired deferred tax benefits recognised within the measurement period that result from new information about facts and circumstances that existed at the acquisition date shall be applied to reduce the carrying amount of any goodwill related to that acquisition. If the carrying amount of that goodwill is zero, any remaining deferred tax benefits shall be recognised in profit or loss.
  - (b) All other acquired deferred tax benefits realised shall be recognised in profit or loss (or, if this Standard so requires, outside profit or loss).

## Current and deferred tax arising from share-based payment transactions

- 68A In some tax jurisdictions, an entity receives a tax deduction (ie an amount that is deductible in determining taxable profit) that relates to remuneration paid in shares, share options or other equity instruments of the entity. The amount of that tax deduction may differ from the related cumulative remuneration expense, and may arise in a later accounting period. For example, in some jurisdictions, an entity may recognise an expense for the consumption of employee services received as consideration for share options granted, in accordance with HKFRS 2 *Share-based Payment*, and not receive a tax deduction until the share options are exercised, with the measurement of the tax deduction based on the entity's share price at the date of exercise.
- 68B As with the research costs discussed in paragraphs 9 and 26(b) of this Standard, the difference between the tax base of the employee services received to date (being the amount the taxation authorities will permit as a deduction in future periods), and the carrying amount of nil, is a deductible temporary difference that results in a deferred tax asset. If the amount the taxation authorities will permit as a deduction in future periods is not known at the end of the period, it shall be estimated, based on information available at the end of the period. For example, if the amount that the taxation authorities will permit as a deduction in future periods is dependent upon the entity's share price at a future date, the measurement of the deductible temporary difference should be based on the entity's share price at the end of the period.
- 68C As noted in paragraph 68A, the amount of the tax deduction (or estimated future tax deduction, measured in accordance with paragraph 68B) may differ from the related cumulative remuneration expense. Paragraph 58 of the Standard requires that current and deferred tax should 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) a transaction or event that is recognised, in the same or a different period, outside profit or loss, or (b) a business combination (other than the acquisition by an investment entity of a subsidiary that is required to be measured at fair value through profit or loss). If the amount of the tax deduction (or estimated future tax deduction) exceeds the amount of the related cumulative remuneration expense, this indicates that the tax deduction relates not only to remuneration expense but also to an equity item. In this situation, the excess of the associated current or deferred tax should be recognised directly in equity.

## Presentation

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### Tax assets and tax liabilities

69 [Deleted]

70 [Deleted]

### Offset

71 **An entity shall offset current tax assets and current tax liabilities if, and only if, the entity:**

- (a) **has a legally enforceable right to set off the recognised amounts; and**
- (b) **intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.**

72 Although current tax assets and liabilities are separately recognised and measured, they are offset in the statement of financial position subject to criteria similar to those



established for financial instruments in HKAS 32. An entity will normally 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.

- 73 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, and only if, the entities concerned have a legally enforceable right to make or receive a single net payment and the entities intend to make or receive such a net payment or to recover the asset and settle the liability simultaneously.
- 74 **An entity shall offset deferred tax assets and deferred tax liabilities if, and only if:**
- (a) **the entity has a legally enforceable right to set off current tax assets against current tax liabilities; and**
  - (b) **the deferred tax assets and the deferred tax liabilities relate to income taxes levied by the same taxation authority on either:**
    - (i) **the same taxable entity; or**
    - (ii) **different taxable entities which intend either to settle current tax liabilities and assets on a net basis, or to realise the assets and settle the liabilities simultaneously, in each future period in which significant amounts of deferred tax liabilities or assets are expected to be settled or recovered.**
- 75 To avoid the need for detailed scheduling of the timing of the reversal of each temporary difference, this Standard requires an entity to set off a deferred tax asset against a deferred tax liability of the same taxable entity if, and only if, they relate to income taxes levied by the same taxation authority and the entity has a legally enforceable right to set off current tax assets against current tax liabilities.
- 76 In rare circumstances, an entity may have a legally enforceable right of set-off, and an intention to settle net, for some periods but not for others. In such rare circumstances, detailed scheduling may be required to establish reliably whether the deferred tax liability of one taxable entity will result in increased tax payments in the same period in which a deferred tax asset of another taxable entity will result in decreased payments by that second taxable entity.

## Tax expense

### Tax expense (income) related to profit or loss from ordinary activities

**77** The tax expense (income) related to profit or loss from ordinary activities shall be presented as part of profit or loss in the statement(s) of profit or loss and other comprehensive income.

**77A** [Deleted]

### Exchange differences on deferred foreign tax liabilities or assets

**78** HKAS 21 requires certain exchange differences to be recognised as income or expense but does not specify where such differences should be presented in the statement of comprehensive income. Accordingly, where exchange differences on deferred foreign tax liabilities or assets are recognised in the statement of comprehensive income, such differences may be classified as deferred tax expense (income) if that presentation is considered to be the most useful to financial statement users.

## Disclosure

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**79** The major components of tax expense (income) shall be disclosed separately.

**80** 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 amount of the benefit arising from a previously unrecognised tax loss, tax credit or temporary difference of a prior period that is used to reduce current tax expense;
- (f) the amount of the benefit from a previously unrecognised tax loss, tax credit or temporary difference of a prior period that is used to reduce deferred tax expense;
- (g) deferred tax expense arising from the write-down, or reversal of a previous write-down, of a deferred tax asset in accordance with paragraph 56; and
- (h) the amount of tax expense (income) relating to those changes in accounting policies and errors that are included in profit or loss in accordance with HKAS 8, because they cannot be accounted for retrospectively.

**81** The following shall also be disclosed separately:

- (a) the aggregate current and deferred tax relating to items that are charged or credited directly to equity (see paragraph 62A);

- (ab) the amount of income tax relating to each component of other comprehensive income (see paragraph 62 and HKAS 1 (as revised in 2007));**
- (b) [deleted];**
- (c) an explanation of the relationship between tax expense (income) and accounting profit in either or both of the following forms:**
  - (i) a numerical reconciliation between tax expense (income) and the product of accounting profit multiplied by the applicable tax rate(s), disclosing also the basis on which the applicable tax rate(s) is (are) computed; or**
  - (ii) a numerical reconciliation between the average effective tax rate and the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed;**
- (d) an explanation of changes in the applicable tax rate(s) compared to the previous accounting period;**
- (e) the amount (and expiry date, if any) of deductible temporary differences, unused tax losses, and unused tax credits for which no deferred tax asset is recognised in the statement of financial position;**
- (f) the aggregate amount of temporary differences associated with investments in subsidiaries, branches and associates and interests in joint arrangements, for which deferred tax liabilities have not been recognised (see paragraph 39);**
- (g) in respect of each type of temporary difference, and in respect of each type of unused tax losses and unused tax credits:**
  - (i) the amount of the deferred tax assets and liabilities recognised in the statement of financial position for each period presented;**
  - (ii) the amount of the deferred tax income or expense recognised in profit or loss, if this is not apparent from the changes in the amounts recognised in the statement of financial position;**
- (h) in respect of discontinued operations, the tax expense relating to:**
  - (i) the gain or loss on discontinuance; and**
  - (ii) the profit or loss from the ordinary activities of the discontinued operation for the period, together with the corresponding amounts for each prior period presented;**
- (i) the amount of income tax consequences of dividends to shareholders of the entity that were proposed or declared before the financial statements were authorised for issue, but are not recognised as a liability in the financial statements;**
- (j) if a business combination in which the entity is the acquirer causes a change in the amount recognised for its pre-acquisition deferred tax asset (see paragraph 67), the amount of that change; and**
- (k) if the deferred tax benefits acquired in a business combination are not recognised at the acquisition date but are recognised after the**

**acquisition date (see paragraph 68), a description of the event or change in circumstances that caused the deferred tax benefits to be recognised.**

**82 An entity shall disclose the amount of a deferred tax asset and the nature of the evidence supporting its recognition, when:**

- (a) the utilisation of the deferred tax asset is dependent on future taxable profits in excess of the profits arising from the reversal of existing taxable temporary differences; and**
- (b) the entity has suffered a loss in either the current or preceding period in the tax jurisdiction to which the deferred tax asset relates.**

**82A In the circumstances described in paragraph 52A, an entity shall disclose the nature of the potential income tax consequences that would result from the payment of dividends to its shareholders. In addition, the entity shall disclose the amounts of the potential income tax consequences practicably determinable and whether there are any potential income tax consequences not practicably determinable.**

83 [Deleted]

84 The disclosures required by paragraph 81(c) enable users of financial statements to understand whether the relationship between tax expense (income) and accounting profit is unusual and to understand the significant factors that could affect that relationship in the future. The relationship between tax expense (income) and accounting profit may be affected by such factors as revenue that is exempt from taxation, expenses that are not deductible in determining taxable profit (tax loss), the effect of tax losses and the effect of foreign tax rates.

85 In explaining the relationship between tax expense (income) and accounting profit, an entity uses an applicable tax rate that provides the most meaningful information to the users of its financial statements. Often, the most meaningful rate is the domestic rate of tax in the country in which the entity is domiciled, aggregating the tax rate applied for national taxes with the rates applied for any local taxes which are computed on a substantially similar level of taxable profit (tax loss). However, for an entity operating in several jurisdictions, it may be more meaningful to aggregate separate reconciliations prepared using the domestic rate in each individual jurisdiction. The following example illustrates how the selection of the applicable tax rate affects the presentation of the numerical reconciliation.

INCOME TAXES

Whilst in most cases, the applicable rate of tax that provides the most meaningful information to users will be the domestic rate of tax in the country in which the entity is domiciled, there will be exceptions. For example, it is common in Hong Kong for groups to have a parent entity domiciled in Bermuda with operating subsidiaries in Hong Kong. In these circumstances, the most meaningful rate of tax will be Hong Kong tax where the majority of the operations are carried out.

**Example Illustrating Paragraph 85**

In 20X2, an entity has accounting profit in its own jurisdiction (country A) of \$1,500 (20X1: \$2,000) and in country B of \$1,500 (20X1: \$500). The tax rate is 30% in country A and 20% in country B. In country A, expenses of \$100 (20X1: \$200) are not deductible for tax purposes.

*The following is an example of a reconciliation to the domestic tax rate.*

	20X1	20X2
	\$	\$
Accounting profit	2,500	3,000
<i>Tax at the domestic rate of 30%</i>	750	900
<i>Tax effect of expenses that are not deductible for tax purposes</i>	60	30
<i>Effect of lower tax rates in country B</i>	(50)	(150)
Tax expense	760	780

*The following is an example of a reconciliation prepared by aggregating separate reconciliations for each national jurisdiction. Under this method, the effect of differences between the reporting entity's own domestic tax rate and the domestic tax rate in other jurisdictions does not appear as a separate item in the reconciliation. An entity may need to discuss the effect of significant changes in either tax rates, or the mix of profits earned in different jurisdictions, in order to explain changes in the applicable tax rate(s), as required by paragraph 81(d).*

	\$	\$
Accounting profit	2,500	3,000
<i>Tax at the domestic rates applicable to profits in the country concerned</i>	700	750
<i>Tax effect of expenses that are not deductible for tax purposes</i>	60	30
Tax expense	760	780

- 86 The average effective tax rate is the tax expense (income) divided by the accounting profit.
- 87 It would often be impracticable to compute the amount of unrecognised deferred tax liabilities arising from investments in subsidiaries, branches and associates and interests in joint arrangements (see paragraph 39). Therefore, this Standard requires an entity to disclose the aggregate amount of the underlying temporary differences but does not require disclosure of the deferred tax liabilities. Nevertheless, where practicable, entities are encouraged to disclose the amounts of the unrecognised deferred tax liabilities because financial statement users may find such information useful.
- 87A Paragraph 82A requires an entity to disclose the nature of the potential income tax consequences that would result from the payment of dividends to its shareholders. An entity discloses the important features of the income tax systems and the factors that will affect the amount of the potential income tax consequences of dividends.
- 87B It would sometimes not be practicable to compute the total amount of the potential income tax consequences that would result from the payment of dividends to shareholders. This may be the case, for example, where an entity has a large number of foreign subsidiaries. However, even in such circumstances, some portions of the total amount may be easily determinable. For example, in a consolidated group, a parent and some of its subsidiaries may have paid income taxes at a higher rate on undistributed profits and be aware of the amount that would be refunded on the payment of future dividends to shareholders from consolidated retained earnings. In this case, that refundable amount is disclosed. If applicable, the entity also discloses that there are additional potential income tax consequences not practicably determinable. In the parent's separate financial statements, if any, the disclosure of the potential income tax consequences relates to the parent's retained earnings.
- 87C An entity required to provide the disclosures in paragraph 82A may also be required to provide disclosures related to temporary differences associated with investments in subsidiaries, branches and associates or interests in joint arrangements. In such cases, an entity considers this in determining the information to be disclosed under paragraph 82A. For example, an entity may be required to disclose the aggregate amount of temporary differences associated with investments in subsidiaries for which no deferred tax liabilities have been recognised (see paragraph 81(f)). If it is impracticable to compute the amounts of unrecognised deferred tax liabilities (see paragraph 87) there may be amounts of potential income tax consequences of dividends not practicably determinable related to these subsidiaries.
- 88 An entity discloses any tax-related contingent liabilities and contingent assets in accordance with HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. *Contingent liabilities and contingent assets* may arise, for example, from unresolved disputes with the taxation authorities. Similarly, where changes in tax rates or tax laws are enacted or announced after the reporting period, an entity discloses any significant effect of those changes on its current and deferred tax assets and liabilities (see HKAS 10 *Events after the Reporting Period*).

## Effective date

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- 89 **This Standard becomes operative for financial statements covering periods beginning on or after 1 January 2005. Earlier adoption is encouraged but not required. If an entity applies this Standard for periods beginning before 1 January 2005, the entity shall disclose that fact and apply Hong Kong Accounting Standards Interpretation (HKAS-INT) 21 *Income Taxes – Recovery of Revalued Non-Depreciable Assets* and HKAS-INT 25 *Income Taxes – Changes in the Tax Status of an Entity or its Shareholders* at the same time.**

- 90 This Standard supersedes SSAP 12 *Income Taxes* (issued in August 2002).
- 91 [Not used]
- 92 HKAS 1 (as revised in 2007) amended the terminology used throughout HKFRSs. In addition it amended paragraphs 23, 52, 58, 60, 62, 63, 65, 68C, 77 and 81, deleted paragraph 61 and added paragraphs 61A, 62A and 77A. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. If an entity applies HKAS 1 (revised 2007) for an earlier period, the amendments shall be applied for that earlier period.
- 93 Paragraph 68 shall be applied prospectively from the effective date of HKFRS 3 (as revised in 2008) to the recognition of deferred tax assets acquired in business combinations.
- 94 Therefore, entities shall not adjust the accounting for prior business combinations if tax benefits failed to satisfy the criteria for separate recognition as of the acquisition date and are recognised after the acquisition date, unless the benefits are recognised within the measurement period and result from new information about facts and circumstances that existed at the acquisition date. Other tax benefits recognised shall be recognised in profit or loss (or, if this Standard so requires, outside profit or loss).
- 95 HKFRS 3 (as revised in 2008) amended paragraphs 21 and 67 and added paragraphs 32A and 81(j) and (k). An entity shall apply those amendments for annual periods beginning on or after 1 July 2009. If an entity applies HKFRS 3 (revised 2008) for an earlier period, the amendments shall also be applied for that earlier period.
- 96 [Deleted]
- 97 [Deleted]
- 98 Paragraph 52 was renumbered as 51A, paragraph 10 and the examples following paragraph 51A were amended, and paragraphs 51B and 51C and the following example and paragraphs 51D, 51E and 99 were added by *Deferred Tax: Recovery of Underlying Assets*, issued in December 2010. An entity shall apply those amendments for annual periods beginning on or after 1 January 2012. Earlier application is permitted. If an entity applies the amendments for an earlier period, it shall disclose that fact.
- 98A HKFRS 11 *Joint Arrangements*, issued in June 2011, amended paragraphs 2, 15, 18(e), 24, 38, 39, 43–45, 81(f), 87 and 87C. An entity shall apply those amendments when it applies HKFRS 11.
- 98B *Presentation of Items of Other Comprehensive Income* (Amendments to HKAS 1), issued in July 2011, amended paragraph 77 and deleted paragraph 77A. An entity shall apply those amendments when it applies HKAS 1 as amended in July 2011.
- 98C *Investment Entities* (Amendments to HKFRS 10, HKFRS 12 and HKAS 27), issued in December 2012, amended paragraphs 58 and 68C. An entity shall apply those amendments for annual periods beginning on or after 1 January 2014. Earlier application of *Investment Entities* is permitted. If an entity applies those amendments earlier it shall also apply all amendments included in *Investment Entities* at the same time.
- 98D [Deleted]
- 98E HKFRS 15 *Revenue from Contracts with Customers*, issued in July 2014, amended paragraph 59. An entity shall apply that amendment when it applies HKFRS 15.

- 98F HKFRS 9, as issued in September 2014, amended paragraph 20 and deleted paragraphs 96, 97 and 98D. An entity shall apply those amendments when it applies HKFRS 9.
- 98G HKFRS 16, issued in May 2016, amended paragraph 20. An entity shall apply that amendment when it applies HKFRS 16.
- 98H *Recognition of Deferred Tax Assets for Unrealised Losses* (Amendments to HKAS 12), issued in January 2016, amended paragraph 29 and added paragraphs 27A, 29A and the example following paragraph 26. An entity shall apply those amendments for annual periods beginning on or after 1 January 2017. Earlier application is permitted. If an entity applies those amendments for an earlier period, it shall disclose that fact. An entity shall apply those amendments retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. However, on initial application of the amendment, the change in the opening equity of the earliest comparative period may be recognised in opening retained earnings (or in another component of equity, as appropriate), without allocating the change between opening retained earnings and other components of equity. If an entity applies this relief, it shall disclose that fact.
- 98I *Annual Improvements to HKFRS Standards 2015–2017 Cycle*, issued in February 2018, added paragraph 57A and deleted paragraph 52B. An entity shall apply those amendments for annual reporting periods beginning on or after 1 January 2019. Earlier application is permitted. If an entity applies those amendments earlier, it shall disclose that fact. When an entity first applies those amendments, it shall apply them to the income tax consequences of dividends recognised on or after the beginning of the earliest comparative period.

## **Withdrawal of HK(SIC)- Int 21**

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- 99 The amendments made by *Deferred Tax: Recovery of Underlying Assets*, issued in December 2010, supersede Hong Kong (SIC) Interpretation 21 *Income Taxes—Recovery of Revalued Non-Depreciable Assets*.

### **Acknowledgement**

**The Hong Kong Institute of Certified Public Accountants is indebted to the Australian Accounting Research Foundation for granting permission to use material from its Standard AASB 1020 "Income taxes" as some of the explanatory guidance and illustrative examples in this Standard.**



## Appendix

### Comparison with International Accounting Standards

This comparison appendix, which was prepared as at October 2004 and deals only with significant differences in the standards extant, is produced for information only and does not form part of the standards in HKAS 12.

The International Accounting Standard comparable with HKAS 12 is IAS 12 *Income Taxes*.

There are no major textual difference between HKAS 12 and IAS 12.

*(Note: The explanatory guidance and illustrative examples set out in the boxes within the body of HKAS 12 contain material that may not be based on the examples in IAS 12 but based on those in Australian Standard AASB 1020, Income Taxes.)*

## Basis for Conclusions on IAS 12 *Income Taxes*

*This Basis for Conclusions accompanies, but is not part of, IAS 12.*

HKAS 12 is based on IAS 12 *Income Taxes*. In approving HKAS 12, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IAS 12. Accordingly, there are no significant differences between HKAS 12 and IAS 12. The IASB's Basis for Conclusions is reproduced below. The paragraph numbers of IAS 12 referred to below generally correspond with those in HKAS 12.

### Introduction

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- BC1 When IAS 12 *Income Taxes* was issued by the International Accounting Standards Committee in 1996 to replace the previous IAS 12 *Accounting for Taxes on Income* (issued in July 1979), the Standard was not accompanied by a Basis for Conclusions. This Basis for Conclusions is not comprehensive. It summarises only the International Accounting Standards Board's considerations in making the amendments to IAS 12 contained in *Deferred Tax: Recovery of Underlying Assets* issued in December 2010. Individual Board members gave greater weight to some factors than to others.
- BC1A In August 2014 the Board published an Exposure Draft of proposed amendments to IAS 12 to clarify the requirements on recognition of deferred tax assets for unrealised losses on debt instruments measured at fair value. The Board subsequently modified and confirmed the proposals and in January 2016 issued *Recognition of Deferred Tax Assets for Unrealised Losses* (Amendments to IAS 12). The Board's considerations and reasons for its conclusions are discussed in paragraphs BC37–BC62.
- BC2 The Board amended IAS 12 to address an issue that arises when entities apply the measurement principle in IAS 12 to temporary differences relating to investment properties that are measured using the fair value model in IAS 40 *Investment Property*.
- BC3 In March 2009 the Board published an exposure draft, *Income Tax* (the 2009 exposure draft), proposing a new IFRS to replace IAS 12. In the 2009 exposure draft, the Board addressed this issue as part of a broad proposal relating to the determination of tax basis. In October 2009 the Board decided not to proceed with the proposals in the 2009 exposure draft and announced that, together with the US Financial Accounting Standards Board, it aimed to conduct a fundamental review of the accounting for income tax in the future. In the meantime, the Board would address specific significant current practice issues.
- BC4 In September 2010 the Board published proposals for addressing one of those practice issues in an exposure draft *Deferred Tax: Recovery of Underlying Assets* with a 60-day comment period. Although that is shorter than the Board's normal 120-day comment period, the Board concluded that this was justified because the amendments were straightforward and the exposure draft was short. In addition, the amendments were addressing a problem that existed in practice and needed to be solved as soon as possible. The Board considered the comments it received on the exposure draft and in December 2010 issued the amendments to IAS 12. The Board intends to address other practice issues arising from IAS 12 in due course, when other priorities on its agenda permit this.

### Recovery of revalued non-depreciable assets

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- BC5 In December 2010, the Board incorporated in paragraph 51B of IAS 12 the consensus previously contained in SIC Interpretation 21 *Income Taxes—Recovery of Revalued Non-Depreciable Assets*. However, because paragraph 51C addresses investment property carried at fair value, the Board excluded such assets from the scope of paragraph 51B. Paragraphs BC6 and BC7 set out the basis that the Standing

Interpretations Committee (SIC) gave for the conclusions it reached in developing the consensus expressed in SIC-21.

- BC6 The SIC noted that the *Framework for the Preparation and Presentation of Financial Statements*<sup>1</sup> stated that an entity recognises an asset if it is probable that the future economic benefits associated with the asset will flow to the entity. Generally, those future economic benefits will be derived (and therefore the carrying amount of an asset will be recovered) through sale, through use, or through use and subsequent sale. Recognition of depreciation implies that the carrying amount of a depreciable asset is expected to be recovered through use to the extent of its depreciable amount, and through sale at its residual value. Consistently with this, the carrying amount of a non-depreciable asset, such as land having an unlimited life, will be recovered only through sale. In other words, because the asset is not depreciated, no part of its carrying amount is expected to be recovered (ie consumed) through use. Deferred taxes associated with the non-depreciable asset reflect the tax consequences of selling the asset.
- BC7 The SIC noted that the expected manner of recovery is not predicated on the basis of measuring the carrying amount of the asset. For example, if the carrying amount of a non-depreciable asset is measured at its value in use, the basis of measurement does not imply that the carrying amount of the asset is expected to be recovered through use, but through its residual value upon ultimate disposal.

## **Recovery of investment properties**

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### **Reason for the exception**

- BC8 IAS 12 applies the principle that the measurement of deferred tax liabilities and deferred tax assets should reflect the tax consequences that would follow from the manner in which the entity expects to recover or settle the carrying amount of its assets and liabilities. In many cases, however, an entity expects to rent out investment property to earn rental income and then sell it to gain from capital appreciation at some point in the future. Without specific plans for disposal of the investment property, it is difficult and subjective to estimate how much of the carrying amount of the investment property will be recovered through cash flows from rental income and how much of it will be recovered through cash flows from selling the asset.
- BC9 It is particularly difficult and subjective to determine the entity's expected manner of recovery for investment property that is measured using the fair value model in IAS 40. In contrast, for investment property that is measured using the cost model in IAS 40, the Board believes that the estimates required for depreciation establish the expected manner of recovery because there is a general presumption that an asset's carrying amount is recovered through use to the extent of the amount subject to depreciation and through sale to the extent of the residual value.
- BC10 To address this issue, the Board introduced an exception to the principle in IAS 12 that applies when an entity adopts an accounting policy of remeasuring investment property at fair value. The purpose of the exception is to reflect the entity's expectation of recovery of the investment property in a practical manner that involves little subjectivity.
- BC11 Many respondents to the exposure draft of September 2010 commented that the Board should develop application guidance rather than creating an exception. The Board could have achieved a similar result in some cases by providing application guidance on how to apply the underlying principle to investment property. However,

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<sup>1</sup> The reference is to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the Board in 2001 and in effect when the SIC discussed this matter.

the Board chose an exception because it is simple, straightforward and can avoid unintended consequences by a strict definition of its scope. In fact, this exception is very similar to application guidance. However, it is technically an exception because, in some cases, the asset's carrying amount is assumed to be recovered entirely through sale even though an entity expects it to be recovered partly through sale and partly through use.

- BC12 The Board also noted that application guidance would not resolve a practice issue that arises when the future income generated from an asset is expected to exceed the carrying amount of that asset and that future income will be subject to two or more different tax regimes. In those situations, IAS 12 provides no basis for determining which tax rate and tax base apply to the recovery of the carrying amount. The Board concluded that the practical way to resolve this issue was to create an exception that determines the manner of recovery of an asset within the scope of that exception.

### Scope of the exception

- BC13 The Board understands that the concerns raised in practice relate primarily to investment property measured using the fair value model in IAS 40. The Board proposed in the exposure draft that the exception should also apply to property, plant and equipment or intangible assets measured using the revaluation model in IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets*. That was because in assessing the difficulty and subjectivity involved in determining the expected manner of recovering the carrying amount of the underlying asset, there is no underlying difference between regularly fair valuing assets through a revaluation accounting policy and applying a fair value measurement model.
- BC14 Many respondents disagreed with the proposal to include property, plant and equipment or intangible assets measured using the revaluation model in IAS 16 or IAS 38 in the scope of the exception. They stated that many items of property, plant and equipment are recovered through use rather than through sale, and that this is consistent with the definition of property, plant and equipment in IAS 16. In addition, many respondents disagreed with the presumption of recovery through sale when the underlying assets are intangible assets for similar reasons. They also warned of unintended consequences that could arise because of the varying nature of intangible assets. Many respondents suggested limiting the scope of the exception to investment properties measured using the fair value model in IAS 40. Having considered those comments, the Board adopted that suggestion.
- BC15 Some respondents supported inclusion of property, plant and equipment in the scope of the exception, including property, plant and equipment measured on a cost basis, because of their concerns about the lack of discounting deferred tax assets and deferred tax liabilities and about a possible double-counting of tax effects (see paragraph BC19). However, the Board concluded that considering concerns about the lack of discounting and about the possible double-counting was outside the limited scope of the amendments.
- BC16 The Board made it clear that the exception also applies on initial measurement of investment property acquired in a business combination if the investment property will subsequently be measured using the fair value model in IAS 40. If the exception did not apply in these circumstances, deferred taxes might reflect the tax consequences of use at the acquisition date, but at a later date reflect the tax consequences of sale. The Board believes that measurement of deferred taxes at the acquisition date should be consistent with the subsequent measurement of the same deferred taxes. For the same reason, the Board concluded that the exception should not apply to investment property initially measured at fair value in a business combination if the entity subsequently uses the cost model.
- BC17 Having considered the responses to the exposure draft, the Board decided not to extend the exception to other underlying assets and liabilities that are measured at

fair value, including financial instruments or biological assets. This is because the Board understands that the most significant current practice issues relate to investment property. In addition, the Board wished to avoid unintended consequences of expanding the scope to other assets and liabilities that are measured on a fair value basis.

- BC18 The Board concluded that the amendments should apply to all temporary differences that arise relating to underlying assets within the scope of the exception, not just those separate temporary differences created by the remeasurement of the underlying asset. This is because the unit of account applied in determining the manner of recovery in the Standard is the underlying asset as a whole, not the individual temporary differences.

### **Measurement basis**

- BC19 The Board decided that when the exception applies, there should be a presumption that deferred taxes should be measured to reflect the tax consequences of recovering the carrying amount of the investment property entirely through sale. In making that decision, the Board considered various views expressed by interested parties, which included, but were not limited to the following:

- (a) the tax effect would be double-counted in some situations if deferred taxes are measured on the basis of the tax consequences of use, because the investment property is measured at fair value, which reflects some of these tax consequences; and
- (b) presuming sale is consistent with a fair value measurement basis that reflects the price that would be received if the investment property is sold.

- BC20 Many respondents to the exposure draft said that choosing a measurement basis of fair value is an accounting policy choice that does not imply or predict recovery of the investment property through sale. Many also said that the proposed exception would solve the double-counting problem partially but not completely. The Board noted that the aim of the exception was neither to link the accounting policy with measurement of deferred taxes (see paragraph BC7), nor to remove completely the double-counting of tax effects (see paragraph BC15). The aim of this exception is to provide a practical approach when determination of the expected manner of recovery is difficult and subjective.

- BC21 In many cases when an entity chooses the fair value model for investment property, investment properties are recovered through sale. Even if an investment property earns income through rental use in a given period, the value of the future earnings capacity of the investment property will often not decrease and that value will ultimately be realised through sale. Therefore, the Board retained its proposal to introduce a presumption of recovery through sale.

- BC22 The Board made that presumption rebuttable because the Board believes that it is not always appropriate to assume the recovery of investment property through sale. The Board initially proposed in the exposure draft that the presumption of recovery through sale is not appropriate when the entity has clear evidence that it will consume the asset's economic benefits throughout its economic life. The Board set a criterion that refers to consumption of the asset's economic benefits, rather than to the recovery of the carrying amount, because the Board understands that there is diverse practice regarding the meaning of the recovery of the carrying amount through use or through sale.

- BC23 After considering the responses to the exposure draft, the Board reworded the rebuttable presumption so that clear evidence would not be required to rebut it. Instead, the presumption is rebutted if an asset is held within a business model whose objective is to consume substantially all of the economic benefits embodied in the investment property over time, rather than through sale. Many respondents were concerned that, because clear evidence is an ambiguous term, the requirement to gather clear evidence would have been onerous for entities that have no problem applying the existing principle in IAS 12, and could have led to abuse by entities that choose whether to gather clear evidence to achieve a favourable result. The Board chose to use the term 'business model' because it is already used in IFRS 9 *Financial Instruments* and would not depend on management's intentions for an individual asset. Many respondents were concerned that the presumption would lead to inappropriate results in some cases because it would not be rebutted if a minor scrap value would be recovered through sale. The Board also reworded the rebuttable presumption in order to respond to those concerns. The Board also made it clear that the presumption of recovery through sale cannot be rebutted if the asset is non-depreciable because that fact implies that no part of the carrying amount of the asset would be consumed through use (see paragraph BC6).
- BC24 The Board also considered other approaches to the measurement of deferred tax liabilities and deferred tax assets when the exception applies, specifically whether deferred taxes should be measured on the basis of the lower of the tax consequences of recovery through use and through sale. However, the Board rejected such an approach, noting that it would have created:
- (a) conceptual and practical concerns about whether deferred tax assets should be measured to reflect the lower of, or higher of, the tax consequences of use and of sale;
  - (b) a measurement basis that some believe would be arbitrary; and
  - (c) concerns that entities might be required to measure deferred taxes on a basis that is inconsistent with their expectations of recovery of the carrying amount of the underlying asset.
- BC25 Some respondents to the exposure draft drew the mistaken conclusion that the exposure draft required presumption of *immediate* sale at the end of the reporting period when assessing the presumption of recovery through sale. The Board observed that paragraph 47 of IAS 12 requires deferred tax assets and liabilities to be measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled on the basis of tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period. This requirement applies even when the presumption of recovery through sale is used. For clarification, the Board adjusted the illustrative example following paragraph 51C to reflect the requirement in paragraph 47.
- BC26 In the exposure draft, the Board proposed to withdraw SIC-21. However, many respondents commented that SIC-21 should be retained in order to avoid unintended consequences. Having considered the responses to the exposure draft, the Board decided to incorporate SIC-21 into IAS 12 in its entirety after excluding from the scope of SIC-21 the investment property subject to the requirement in paragraph 51C.

## Assessment of deferred tax assets

- BC27 The Board inserted paragraph 51E to confirm that the requirements in paragraphs 24–33 (deductible temporary differences) and paragraphs 34–36 (unused tax losses and unused tax credits) relating to assessment of deferred tax assets continue to apply even when the presumption of recovery through sale arises. The Board did not think that additional guidance would be necessary.

## Disclosure requirement

- BC28 The Board proposed in the exposure draft disclosure of the fact of, and reasons for, the rebuttal of the presumption of recovery through sale if the entity has rebutted the presumption. However, many respondents said that this disclosure would add little or no value to the financial statements. IAS 1 *Presentation of Financial Statements* already requires disclosures regarding material judgements. Thus, there is no need to disclose a particular judgement on specific types of assets. The Board was convinced by those arguments and did not proceed with the proposed disclosure requirement.

## The costs and benefits of the amendments to IAS 12

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- BC29 Computation of the tax consequences of selling assets is complex in some tax jurisdictions and there are concerns that the amendments to IAS 12 will increase the administrative burden for some entities in those tax jurisdictions.
- BC30 However, the Board believes that the benefit of providing the exception outweighs this potential increase in administrative burden for some entities. This is because the purpose of the exception is to enable preparers to measure deferred taxes in these circumstances in the least subjective manner and in so doing enhance the comparability of financial information about deferred taxes for the benefit of users of financial statements. It is also expected to result in an overall reduction of the administrative burden for entities that have previously had to consider the tax consequence of both use and sale of an investment property when measuring deferred taxes.
- BC31 Many respondents to the exposure draft said that entities would not benefit from the amendments in jurisdictions in which this practice issue did not exist but would suffer from an increased administrative burden as a result of the amendments. Their criticism mainly focused on the rebuttable presumption, as discussed in paragraphs BC22 and BC23. They also said that the disclosure requirement proposed in the exposure draft would be onerous.
- BC32 After considering the responses to the exposure draft, the Board narrowed the scope of the exception to apply only to investment property carried at fair value. It reworded the rebuttable presumption so that clear evidence would no longer be required to rebut the presumption. The Board also did not pursue the proposed disclosure requirement regarding the fact of, and reason for, the rebuttal. After those changes, the Board believes that the amendments will not be onerous for entities that have previously been able to establish without difficulty how they expect to recover investment property carried at fair value.

## Transition and effective date

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- BC33 IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires an entity to apply retrospectively a change in accounting policy resulting from the initial application of an IFRS that does not have a transition provision. The Board did not include any transition provision in the amendments because, in the Board's view, it would not be unduly burdensome for entities to apply the changes to IAS 12 retrospectively.

- BC34 The Board acknowledges that the amendments may add some administrative burden if they apply to investment property acquired in a business combination that occurred in a previous reporting period. For example, it could be difficult to restate goodwill and recalculate previous impairment reassessments if some information is not available and an entity is unable to separate the effects of hindsight. However, the Board reasoned that the amendments apply only to specific circumstances. Moreover, IAS 8 provides sufficient guidance to deal with cases when it might be impracticable to reassess impairment of goodwill or recoverability of deferred tax assets.
- BC35 Consequently, the Board concluded that the cost of requiring retrospective application is outweighed by the benefit of consistent application of the amendments by entities to all periods presented in the financial statements. Accordingly, the Board decided that entities should apply the amendments to IAS 12 retrospectively in accordance with IAS 8.

### **First-time adoption of IFRSs**

- BC36 The Board identified no reason to adjust the exception for application by a first-time adopter at its date of transition to IFRSs.

### ***Recognition of Deferred Tax Assets for Unrealised Losses (2016 amendments)***

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- BC37 The IFRS Interpretations Committee (the 'Interpretations Committee') was asked to provide guidance on how an entity determines, in accordance with IAS 12, whether to recognise a deferred tax asset when:
- (a) the entity has a debt instrument that is classified as an available-for-sale financial asset in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*.<sup>2</sup> Changes in the market interest rate result in a decrease in the fair value of the debt instrument to below its cost (ie it has an 'unrealised loss');
  - (b) it is probable that the issuer of the debt instrument will make all the contractual payments;
  - (c) the tax base of the debt instrument is cost;
  - (d) tax law does not allow a loss to be deducted on a debt instrument until the loss is realised for tax purposes;
  - (e) the entity has the ability and intention to hold the debt instrument until the unrealised loss reverses (which may be at its maturity);
  - (f) tax law distinguishes between capital gains and losses and ordinary income and losses. While capital losses can only be offset against capital gains, ordinary losses can be offset against both capital gains and ordinary income; and
  - (g) the entity has insufficient taxable temporary differences and no other probable taxable profits against which the entity can utilise deductible temporary differences.
- BC38 The Interpretations Committee reported to the Board that practice differed because of divergent views on the following questions:
- (a) Do decreases in the carrying amount of a fixed-rate debt instrument for which the principal is paid on maturity always give rise to a deductible

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<sup>2</sup> IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39. Under IFRS 9, the same question arises for debt instruments measured at fair value.



temporary difference if this debt instrument is measured at fair value and if its tax base remains at cost? In particular, do they give rise to a deductible temporary difference if the debt instrument's holder expects to recover the carrying amount of the asset by use, ie continuing to hold it, and if it is probable that the issuer will pay all the contractual cash flows? (see paragraphs BC39–BC45)

- (b) Does an entity assume that it will recover an asset for more than its carrying amount when estimating probable future taxable profit against which deductible temporary differences are assessed for utilisation if such recovery is probable? This question is relevant when taxable profit from other sources is insufficient for the utilisation of the deductible temporary differences related to debt instruments measured at fair value. In this case, an entity may only be able to recognise deferred tax assets for its deductible temporary differences if it is probable that it will collect the entire cash flows from the debt instrument and therefore recover it for more than its carrying amount. (see paragraphs BC46–BC54)
- (c) When an entity assesses whether it can utilise deductible temporary differences against probable future taxable profit, does that probable future taxable profit include the effects of reversing deductible temporary differences? (see paragraphs BC55–BC56)
- (d) Does an entity assess whether a deferred tax asset is recognised for each deductible temporary difference separately or in combination with other deductible temporary differences? This question is relevant, for example, when tax law distinguishes capital gains and losses from other taxable gains and losses and capital losses can only be offset against capital gains. (see paragraphs BC57–BC59)

### Existence of a deductible temporary difference

- BC39 In the case of many debt instruments, the collection of the principal on maturity does not increase or decrease taxable profit that is reported for tax purposes. This is the case in the example illustrating paragraph 26(d) of IAS 12. Interest is paid at the contractual rate each year, and on maturity of the debt instrument the issuer pays the principal of CU1,000. In this example, if the investor continues to hold the debt instrument, the investor only pays taxes on the interest income. The collection of the principal does not trigger any tax payments.
- BC40 Because the collection of the principal does not increase or decrease the taxable profit that is reported for tax purposes, some thought that the collection of the principal is a non-taxable event. Sometimes, tax law does not explicitly address whether the collection of the principal has tax consequences. Consequently, proponents of this view thought that a difference between the carrying amount of the debt instrument in the statement of financial position and its higher tax base does not give rise to a deductible temporary difference, if this difference results from a loss that they expect will not be realised for tax purposes.
- BC41 Those who held this view thought that the loss would not be realised for tax purposes if the entity has the ability and intention to hold the debt instrument over the period until the loss reverses, which might be until maturity, and it is probable that the entity will receive all the contractual cash flows. In this case, differences between the carrying amount of the debt instrument in the statement of financial position and its tax base reverse over the period to maturity, as a result of continuing to hold the debt instrument.
- BC42 The Board considered the guidance in IAS 12 on the identification of temporary differences and rejected the reasoning presented in paragraphs BC40 and BC41. Paragraphs 20 and 26(d) of IAS 12 specify that a difference between the carrying

amount of an asset measured at fair value and its higher tax base gives rise to a deductible temporary difference. This is because the calculation of a temporary difference in IAS 12 is based on the premise that the entity will recover the carrying amount of an asset, and hence economic benefits will flow to the entity in future periods to the extent of the asset's carrying amount at the end of the reporting period. In contrast, the view presented in paragraphs BC40 and BC41 is based on the assessment of the economic benefits that are expected at maturity. The Board noted that the existence of a deductible temporary difference depends solely on a comparison of the carrying amount of an asset and its tax base at the end of the reporting period, and is not affected by possible future changes in the carrying amount.

- BC43 Consequently, the Board concluded that decreases below cost in the carrying amount of a fixed-rate debt instrument measured at fair value for which the tax base remains at cost give rise to a deductible temporary difference. This applies irrespective of whether the debt instrument's holder expects to recover the carrying amount of the debt instrument by sale or by use, ie continuing to hold it, or whether it is probable that the issuer will pay all the contractual cash flows. Normally, the collection of the entire principal does not increase or decrease taxable profit that is reported for tax purposes, because the tax base equals the inflow of taxable economic benefits when the principal is paid. Typically, the tax base of the debt instrument is deducted either on sale or on maturity.
- BC44 The economic benefit embodied in the related deferred tax asset arises from the ability of the holder of the debt instrument to achieve future taxable gains in the amount of the deductible temporary difference without paying taxes on those gains. In contrast, an entity that acquires the debt instrument described in the example illustrating paragraph 26(d) of IAS 12 for its fair value at the end of Year 2 (in the example, CU918) and continues to hold it, has to pay taxes on a gain of CU82, whereas the entity in that example will not pay any taxes on the collection of the CU1,000 of principal. The Board concluded that it was appropriate for the different tax consequences for these two holders of the same instrument to be reflected in the deferred tax accounting for the debt instrument.
- BC45 The Board has added an example after paragraph 26 of IAS 12 to illustrate the identification of a deductible temporary difference in the case of a fixed-rate debt instrument measured at fair value for which the principal is paid on maturity.

### **Recovering an asset for more than its carrying amount**

- BC46 The Board noted that paragraph 29 of IAS 12 identifies taxable profit in future periods as one source of taxable profits against which an entity can utilise deductible temporary differences. Future taxable profit has to be probable to justify the recognition of deferred tax assets.
- BC47 The guidance in paragraph 29 of IAS 12 does not refer to the carrying amount of assets within the context of estimating probable future taxable profit. Some thought, however, that the carrying amount of an asset to which a temporary difference is related limits the estimate of future taxable profit. They argued that accounting for deferred taxes should be based on consistent assumptions, which implies that an entity cannot assume that, for one and the same asset, the entity will recover it:
- (a) for its carrying amount when determining deductible temporary differences and taxable temporary differences; as well as
  - (b) for more than its carrying amount when estimating probable future taxable profit against which deductible temporary differences are assessed for utilisation.

- BC48 Consequently, proponents of this view thought that an entity cannot assume that it will collect the entire principal of CU1,000 in the example illustrating paragraph 26(d) of IAS 12 when determining probable future taxable profit. Instead, they thought that an entity must assume that it will collect only the carrying amount of the asset.
- BC49 The Board noted however that determining temporary differences and estimating probable future taxable profit against which deductible temporary differences are assessed for utilisation are two separate steps and the carrying amount of an asset is relevant only to determining temporary differences. The carrying amount of an asset does not limit the estimation of probable future taxable profit. In its estimate of probable future taxable profit, an entity includes the probable inflow of taxable economic benefits that results from recovering an asset. This probable inflow of taxable economic benefits may exceed the carrying amount of the asset.
- BC50 Moreover, a limitation on the estimate of probable future taxable profit by the carrying amount of assets can lead to inappropriate results in other scenarios. For example, a significant part of the assets of a profitable manufacturing entity is property, plant and equipment and inventories. Property, plant and equipment may be measured using the cost model (paragraph 30 of IAS 16 *Property, Plant and Equipment*) and inventories are measured at the lower of cost and net realisable value (paragraph 9 of IAS 2 *Inventories*). If such an entity expects to generate future taxable profit, it may be inconsistent to assume that it will only recover these assets for their carrying amount. This is because a significant part of the manufacturing entity's probable future taxable profit results from using those assets to generate taxable profit in excess of their carrying amount.
- BC51 If a limitation such as the one described in paragraph BC50 was made, then, for the purpose of consistency, the entity would need to assume that it will not recover any of its assets for more than their carrying amount. The Board decided that it would not be appropriate to limit the estimate of probable future taxable profit to the carrying amount of related assets only for assets to which temporary differences are related, because there is no basis for a different assessment that would depend on whether a deductible temporary difference is related to an asset or not.
- BC52 Some respondents to the Exposure Draft expressed concern that the guidance might be applied more broadly, and in their view, inappropriately, to other assets, and not merely to debt instruments measured at fair value. Some other respondents were concerned that any guidance would give the false impression that future taxable profit should be estimated on an individual asset basis. The Board noted that the principle that the estimate of probable future taxable profit includes an expected recovery of assets for more than their carrying amounts is not limited to any specific type or class of assets.
- BC53 However, the Board also noted that there are cases in which it may not be probable that an asset will be recovered for more than its carrying amount. An entity should not inappropriately assume that an asset will be recovered for more than its carrying amount. The Board thought that this is particularly important when the asset is measured at fair value. In response to that concern, the Board noted that entities will need to have sufficient evidence on which to base their estimate of probable future taxable profit, including when that estimate involves the recovery of an asset for more than its carrying amount. For example, in the case of a fixed-rate debt instrument measured at fair value, the entity may judge that the contractual nature of future cash flows, as well as the assessment of the likelihood that those contractual cash flows will be received, adequately supports the conclusion that it is probable that it will recover the fixed-rate debt instrument for more than its carrying amount, if the expected cash flows exceed the debt instrument's carrying amount. The Board thought that such an example could enhance understanding and reduce the risk of arbitrary estimates of future taxable profit.

- BC54 The Board has added paragraph 29A to IAS 12 to clarify to what extent an entity's estimate of future taxable profit (paragraph 29) includes amounts from recovering assets for more than their carrying amounts.

### **Probable future taxable profit against which deductible temporary differences are assessed for utilisation**

- BC55 The Interpretations Committee observed that there is uncertainty about how to determine probable future taxable profit against which deductible temporary differences are assessed for utilisation when this profit is being assessed to determine the recognition of all deferred tax assets. The uncertainty relates to whether the probable future taxable profit should include or exclude deductions that will arise when those deductible temporary differences reverse.

- BC56 The Board noted that deductible temporary differences are utilised by deduction against taxable profit, excluding deductions arising from reversal of those deductible temporary differences. Consequently, taxable profit used for assessing the utilisation of deductible temporary differences is different from taxable profit on which income taxes are payable, as defined in paragraph 5 of IAS 12. If those deductions were not excluded, then they would be counted twice. The Board has amended paragraph 29(a) to clarify this.

### **Combined versus separate assessment**

- BC57 The Board considered the guidance in IAS 12 on the recognition of deferred tax assets. Paragraph 24 of IAS 12 requires deferred tax assets to be recognised only to the extent of probable future taxable profit against which the deductible temporary differences can be utilised. Paragraph 27 explains that:

- (a) the deductible temporary differences are utilised when their reversal results in deductions that are offset against taxable profits of future periods; and
- (b) economic benefits in the form of reductions in tax payments will flow to the entity only if it earns sufficient taxable profits against which the deductions can be offset.

- BC58 The Board noted that:

- (a) tax law determines which deductions are offset against taxable income in determining taxable profits. The Board also noted that paragraph 5 of IAS 12 defines taxable profit as the profit of a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable.
- (b) no deferred tax asset is recognised if the reversal of the deductible temporary difference will not lead to tax deductions.

- BC59 Consequently, if tax law offsets a deduction against taxable income on an entity basis, without segregating deductions from different sources, an entity carries out a combined assessment of all its deductible temporary differences relating to the same taxation authority and the same taxable entity. However, if tax law offsets specific types of losses only against a particular type, or types, of income (for example, if tax law limits the offset of capital losses to capital gains), an entity assesses a deductible temporary difference in combination with other deductible temporary differences of that type(s), but separately from other deductible temporary differences. Segregating deductible temporary differences in accordance with tax law and assessing them on such a basis is necessary to determine whether taxable profits are sufficient to utilise deductible temporary differences. The Board has added paragraph 27A to IAS 12 to clarify this.

## Transition

- BC60 The Board decided to require the adjustment of comparative information for any earlier periods presented. However, this amendment allows the change in opening equity of the earliest comparative period presented that arises upon the first application of the amendment to be recognised in opening retained earnings (or in another component of equity, as appropriate), without the need to allocate the change between opening retained earnings and other components of equity. This is to avoid undue cost and effort.
- BC61 The Board noted that, with the exception of the amounts that would have to be adjusted within equity, the accounting required by these amendments is based on amounts and estimates at the end of the reporting periods. The changes to the accounting are mechanical in nature and so the Board expects that the cost of adjusting comparatives should not exceed the benefits of greater comparability.
- BC62 The Board has not added additional transition relief for first-time adopters. This is consistent with the fact that IFRS 1 *First-time Adoption of International Financial Reporting Standards* does not include an exception to, or exemption from, the retrospective application of the requirements in IAS 12.

## **Income tax consequences of payments on financial instruments classified as equity (amendments issued in December 2017)**

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- BC63 The Board was asked about the income tax consequences of payments on financial instruments classified as equity; should an entity recognise them in profit or loss, or in equity? In particular, the Board was asked whether the requirements in paragraph 57A (paragraph 52B before the amendments were made) apply only in the circumstances described in paragraph 52A (for example, when there are different tax rates for distributed and undistributed profits), or whether those requirements apply as long as payments on financial instruments classified as equity are distributions of profit.
- BC64 The Board observed that:
- (a) paragraph 57A describes how an entity accounts for income tax consequences of dividends paid. Dividends are defined in IFRS 9 as 'distributions of profits to holders of equity instruments in proportion to their holdings of a particular class of capital'.
  - (b) paragraph 57A first requires an entity to link the income tax consequences of dividends to past transactions or events that generated distributable profits. An entity then applies the requirements in paragraph 58 to determine where to recognise those income tax consequences. Applying paragraph 57A, the entity recognises the income tax consequences of dividends according to where it has recognised the past transactions or events that generated distributable profits.
  - (c) the reason for the income tax consequences of dividends should not affect where those income tax consequences are recognised. It does not matter whether such consequences arise, for example, because of different tax rates for distributed and undistributed profits or because of the deductibility of dividends for tax purposes. This is because, in both cases, the income tax consequences arise from the distribution of profits.
  - (d) linking the recognition of the income tax consequences of dividends to how the tax consequences arise (for example, because of different tax rates, rather than because of different tax-deductibility rules) would lead to arbitrary results and a lack of comparability across entities in different tax jurisdictions. Tax jurisdictions choose different methods of imposing tax or providing tax relief. What matters is the resulting tax effect, not the mechanism.

- BC65 Accordingly, the Board concluded that an entity should recognise all income tax consequences of dividends applying the requirements in paragraph 57A. However, the Board also observed that, before those requirements were amended, the requirements in paragraph 57A could be misread to imply that paragraph 57A applied only in the circumstances described in paragraph 52A.
- BC66 Consequently, the Board clarified that the requirements in paragraph 57A apply to all income tax consequences of dividends.
- BC67 The Board noted that the amendments do not suggest that an entity applies paragraph 57A to the income tax consequences of all payments on financial instruments classified as equity. Rather, paragraph 57A applies only when an entity determines payments on such instruments are distributions of profits (ie dividends). An entity may need to apply judgement in making this determination.
- BC68 The Board considered whether to include requirements on how to determine if payments on financial instruments classified as equity are distributions of profits. It decided not to do so for the following reasons:
- (a) including indicators or requirements that distinguish distributions of profits from other distributions goes beyond the scope of the amendments to IAS 12. Any attempt by the Board to define or describe distributions of profits could affect other IFRS Standards and IFRIC Interpretations, and risks unintended consequences.
  - (b) the amendments do not change what is and is not a distribution of profits. They simply clarify that the requirements in paragraph 57A apply to all income tax consequences of dividends.
- BC69 The Board concluded that finalising the amendments without adding the possible requirements mentioned in paragraph BC68 would nonetheless be beneficial to preparers and users of financial statements. In particular, the amendments would eliminate the potential for inconsistent accounting that resulted from the ambiguity of the scope of the requirements in paragraph 57A that existed before those requirements were amended.

## Transition

- BC70 The Board decided that an entity applies the amendments to income tax consequences of dividends recognised on or after the beginning of the earliest comparative period when it first applies the amendments. This is because application of the amendments before that date could affect only components of equity as at the beginning of the earliest comparative period. The Board concluded that entities would have sufficient information to apply the amendments to the income tax consequences of dividends that occur in comparative reporting periods and that applying the amendments in this way will enhance comparability of reporting periods.

## ILLUSTRATIVE EXAMPLES

*These illustrative examples accompany, but is not part of, IAS 12.*

### Examples of temporary differences

#### A. Examples of circumstances that give rise to taxable temporary differences

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*All taxable temporary differences give rise to a deferred tax liability.*

##### Transactions that affect profit or loss

- 1 Interest revenue is received in arrears and is included in accounting profit on a time apportionment basis but is included in taxable profit on a cash basis.
- 2 Revenue from the sale of goods is included in accounting profit when goods are delivered but is included in taxable profit when cash is collected. (*note: as explained in B3 below, there is also a **deductible** temporary difference associated with any related inventory*).
- 3 Depreciation of an asset is accelerated for tax purposes.
- 4 Development costs have been capitalised and will be amortised to the statement of comprehensive income but were deducted in determining taxable profit in the period in which they were incurred.
- 5 Prepaid expenses have already been deducted on a cash basis in determining the taxable profit of the current or previous periods.

##### Transactions that affect the statement of financial position

- 6 Depreciation of an asset is not deductible for tax purposes and no deduction will be available for tax purposes when the asset is sold or scrapped. (*note: paragraph 15(b) of the Standard prohibits recognition of the resulting deferred tax liability unless the asset was acquired in a business combination, see also paragraph 22 of the Standard.*)
- 7 A borrower records a loan at the proceeds received (which equal the amount due at maturity), less transaction costs. Subsequently, the carrying amount of the loan is increased by amortisation of the transaction costs to accounting profit. The transaction costs were deducted for tax purposes in the period when the loan was first recognised. (*notes: (1) the taxable temporary difference is the amount of transaction costs already deducted in determining the taxable profit of current or prior periods, less the cumulative amount amortised to accounting profit; and (2) as the initial recognition of the loan affects taxable profit, the exception in paragraph 15(b) of the Standard does not apply. Therefore, the borrower recognises the deferred tax liability.*)
- 8 A loan payable was measured on initial recognition at the amount of the net proceeds, net of transaction costs. The transaction costs are amortised to accounting profit over the life of the loan. Those transaction costs are not deductible in determining the taxable profit of future, current or prior periods. (*notes: (1) the taxable temporary difference is the amount of unamortised transaction costs; and (2) paragraph 15(b) of the Standard prohibits recognition of the resulting deferred tax liability.*)
- 9 The liability component of a compound financial instrument (for example a convertible bond) is measured at a discount to the amount repayable on maturity (see IAS 32

*Financial Instruments: Presentation*). The discount is not deductible in determining taxable profit (tax loss).

### **Fair value adjustments and revaluations**

- 10 Financial assets or investment property are carried at fair value which exceeds cost but no equivalent adjustment is made for tax purposes.
- 11 An entity revalues property, plant and equipment (under the revaluation model treatment in IAS 16 *Property, Plant and Equipment*) but no equivalent adjustment is made for tax purposes. *(note: paragraph 61A of the Standard requires the related deferred tax to be recognised in other comprehensive income.)*

### **Business combinations and consolidation**

- 12 The carrying amount of an asset is increased to fair value in a business combination and no equivalent adjustment is made for tax purposes. *(Note that on initial recognition, the resulting deferred tax liability increases goodwill or decreases the amount of any bargain purchase gain recognised. See paragraph 66 of the Standard.)*
- 13 Reductions in the carrying amount of goodwill are not deductible in determining taxable profit and the cost of the goodwill would not be deductible on disposal of the business. *(Note that paragraph 15(a) of the Standard prohibits recognition of the resulting deferred tax liability.)*
- 14 Unrealised losses resulting from intragroup transactions are eliminated by inclusion in the carrying amount of inventory or property, plant and equipment.
- 15 Retained earnings of subsidiaries, branches, associates and joint ventures are included in consolidated retained earnings, but income taxes will be payable if the profits are distributed to the reporting parent. *(note: paragraph 39 of the Standard prohibits recognition of the resulting deferred tax liability if the parent, investor or venturer is able to control the timing of the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.)*
- 16 Investments in foreign subsidiaries, branches or associates or interests in foreign joint ventures are affected by changes in foreign exchange rates. *(notes: (1) there may be either a taxable temporary difference or a deductible temporary difference; and (2) paragraph 39 of the Standard prohibits recognition of the resulting deferred tax liability if the parent, investor or venturer is able to control the timing of the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.)*
- 17 The non-monetary assets and liabilities of an entity are measured in its functional currency but the taxable profit or tax loss is determined in a different currency. *(notes: (1) there may be either a taxable temporary difference or a deductible temporary difference; (2) where there is a taxable temporary difference, the resulting deferred tax liability is recognised (paragraph 41 of the Standard); and (3) the deferred tax is recognised in profit or loss, see paragraph 58 of the Standard.)*

### **Hyperinflation**

- 18 Non-monetary assets are restated in terms of the measuring unit current at the end of the reporting period (see IAS 29 *Financial Reporting in Hyperinflationary Economies*) and no equivalent adjustment is made for tax purposes. *(notes: (1) the deferred tax is recognised in profit or loss; and (2) if, in addition to the restatement, the non-monetary assets are also revalued, the deferred tax relating to the revaluation is recognised in other comprehensive income and the deferred tax relating to the restatement is recognised in profit or loss.)*



## B. Examples of circumstances that give rise to deductible temporary differences

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*All deductible temporary differences give rise to a deferred tax asset. However, some deferred tax assets may not satisfy the recognition criteria in paragraph 24 of the Standard.*

### Transactions that affect profit or loss

- 1 Retirement benefit costs are deducted in determining accounting profit as service is provided by the employee, but are not deducted in determining taxable profit until the entity pays either retirement benefits or contributions to a fund. (*note: similar deductible temporary differences arise where other expenses, such as product warranty costs or interest, are deductible on a cash basis in determining taxable profit.*)
- 2 Accumulated depreciation of an asset in the financial statements is greater than the cumulative depreciation allowed up to the end of the reporting period for tax purposes.
- 3 The cost of inventories sold before the end of the reporting period is deducted in determining accounting profit when goods or services are delivered but is deducted in determining taxable profit when cash is collected. (*note: as explained in A2 above, there is also a **taxable** temporary difference associated with the related trade receivable.*)
- 4 The net realisable value 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 an entity therefore reduces the carrying amount of the asset, but that reduction is ignored for tax purposes until the asset is sold.
- 5 Research costs (or organisation or other start up costs) are recognised as an expense in determining accounting profit but are not permitted as a deduction in determining taxable profit until a later period.
- 6 Income is deferred in the statement of financial position but has already been included in taxable profit in current or prior periods.
- 7 A government grant which is included in the statement of financial position as deferred income will not be taxable in future periods. (*note: paragraph 24 of the Standard prohibits the recognition of the resulting deferred tax asset, see also paragraph 33 of the Standard.*)

### Fair value adjustments and revaluations

- 8 Financial assets or investment property are carried at fair value which is less than cost, but no equivalent adjustment is made for tax purposes.

### Business combinations and consolidation

- 9 A liability is recognised at its fair value in a business combination, but none of the related expense is deducted in determining taxable profit until a later period. (*Note that the resulting deferred tax asset decreases goodwill or increases the amount of any bargain purchase gain recognised. See paragraph 66 of the Standard.*)
- 10 [Deleted]
- 11 Unrealised profits resulting from intragroup transactions are eliminated from the carrying amount of assets, such as inventory or property, plant or equipment, but no equivalent adjustment is made for tax purposes.

- 12 Investments in foreign subsidiaries, branches or associates or interests in foreign joint ventures are affected by changes in foreign exchange rates. *(notes: (1) there may be a taxable temporary difference or a deductible temporary difference; and (2) paragraph 44 of the Standard requires recognition of the resulting deferred tax asset to the extent, and only to the extent, that it is probable that: (a) the temporary difference will reverse in the foreseeable future; and (b) taxable profit will be available against which the temporary difference can be utilised).*
- 13 The non-monetary assets and liabilities of an entity are measured in its functional currency but the taxable profit or tax loss is determined in a different currency. *(notes: (1) there may be either a taxable temporary difference or a deductible temporary difference; (2) where there is a deductible temporary difference, the resulting deferred tax asset is recognised to the extent that it is probable that sufficient taxable profit will be available (paragraph 41 of the Standard); and (3) the deferred tax is recognised in profit or loss, see paragraph 58 of the Standard.)*

### **C. Examples of circumstances where the carrying amount of an asset or liability is equal to its tax base**

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- 1 Accrued expenses have already been deducted in determining an entity's current tax liability for the current or earlier periods.
- 2 A loan payable is measured at the amount originally received and this amount is the same as the amount repayable on final maturity of the loan.
- 3 Accrued expenses will never be deductible for tax purposes.
- 4 Accrued income will never be taxable.

## Illustrative computations and presentation

*Extracts from statements of financial position and statements of comprehensive income are provided to show the effects on these financial statements of the transactions described below. These extracts do not necessarily conform with all the disclosure and presentation requirements of other Standards.*

All the examples below assume that the entities concerned have no transaction other than those described.

### Example 1 - Depreciable assets

An entity buys equipment for \$10,000 and depreciates it on a straight line basis over its expected useful life of five years. For tax purposes, the equipment is depreciated at 25% a year on a straight line basis. Tax losses may be carried back against taxable profit of the previous five years. In year 0, the entity's taxable profit was \$5,000. The tax rate is 40%.

The entity will recover the carrying amount of the equipment by using it to manufacture goods for resale. Therefore, the entity's current tax computation is as follows:

	Year				
	1	2	3	4	5
Taxable income	2,000	2,000	2,000	2,000	2,000
Depreciation for tax purposes	2,500	2,500	2,500	2,500	0
Taxable profit (tax loss)	<u>(500)</u>	<u>(500)</u>	<u>(500)</u>	<u>(500)</u>	<u>2,000</u>
Current tax expense (income) at 40%	<u><u>(200)</u></u>	<u><u>(200)</u></u>	<u><u>(200)</u></u>	<u><u>(200)</u></u>	<u><u>800</u></u>

The entity recognises a current tax asset at the end of years 1 to 4 because it recovers the benefit of the tax loss against the taxable profit of year 0.

The temporary differences associated with the equipment and the resulting deferred tax asset and liability and deferred tax expense and income are as follows:

INCOME TAXES

	Year				
	1	2	3	4	5
Carrying amount	8,000	6,000	4,000	2,000	0
Tax base	7,500	5,000	2,500	0	0
Taxable temporary difference	<u>500</u>	<u>1,000</u>	<u>1,500</u>	<u>2,000</u>	<u>0</u>
Opening deferred tax liability	0	200	400	600	800
Deferred tax expense (income)	200	200	200	200	(800)
Closing deferred tax liability	<u>200</u>	<u>400</u>	<u>600</u>	<u>800</u>	<u>0</u>

The entity recognises the deferred tax liability in years 1 to 4 because the reversal of the taxable temporary difference will create taxable income in subsequent years. The entity's statement of comprehensive income includes the following:

	Year				
	1	2	3	4	5
Income	2,000	2,000	2,000	2,000	2,000
Depreciation	2,000	2,000	2,000	2,000	2,000
Profit before tax	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Current tax expense (income)	(200)	(200)	(200)	(200)	800
Deferred tax expense (income)	200	200	200	200	(800)
Total tax expense (income)	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Profit for the period	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>

## Example 2 - Deferred tax assets and liabilities

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The example deals with an entity over the two-year period, X5 and X6. In X5 the enacted income tax rate was 40% of taxable profit. In X6 the enacted income tax rate was 35% of taxable profit.

Charitable donations are recognised as an expense when they are paid and are not deductible for tax purposes.

In X5, the entity was notified by the relevant authorities that they intend to pursue an action against the entity with respect to sulphur emissions. Although as at December X6 the action had not yet come to court the entity recognised a liability of 700 in X5 being its best estimate of the fine arising from the action. Fines are not deductible for tax purposes.

In X2, the entity incurred 1,250 of costs in relation to the development of a new product. These costs were deducted for tax purposes in X2. For accounting purposes, the entity capitalised this expenditure and amortised it on the straight-line basis over five years. At 31/12/X4, the unamortised balance of these product development costs was 500.

In X5, the entity entered into an agreement with its existing employees to provide healthcare benefits to retirees. The entity recognises as an expense the cost of this plan as employees provide service. No payments to retirees were made for such benefits in X5 or X6. Healthcare costs are deductible for tax purposes when payments are made to retirees. The entity has determined that it is probable that taxable profit will be available against which any resulting deferred tax asset can be utilised.

Buildings are depreciated for accounting purposes at 5% a year on a straight line basis and at 10% a year on a straight line basis for tax purposes. Motor vehicles are depreciated for accounting purposes at 20% a year on a straight line basis and at 25% a year on a straight line basis for tax purposes. A full year's depreciation is charged for accounting purposes in the year that an asset is acquired.

At 1/1/X6, the building was revalued to 65,000 and the entity estimated that the remaining useful life of the building was 20 years from the date of the revaluation. The revaluation did not affect taxable profit in X6 and the taxation authorities did not adjust the tax base of the building to reflect the revaluation. In X6, the entity transferred \$1,033 from revaluation surplus to retained earnings. This represents the difference of 1,590 between the actual depreciation on the building (3,250) and equivalent depreciation based on the cost of the building (1,660, which is the book value at 1/1/X6 of 33,200 divided by the remaining useful life of 20 years), less the related deferred tax of \$557 (see paragraph 64 of the Standard).

INCOME TAXES

**Current tax expense**

	X5	X6
Accounting profit	8,775	8,740
<i>Add</i>		
Depreciation for accounting purposes	4,800	8,250
Charitable donations	500	350
Fine for environmental pollution	700	-
Product development costs	250	250
Healthcare benefits	2,000	1,000
	<hr/> 17,025	<hr/> 18,590
<i>Deduct</i>		
Depreciation for tax purposes	(8,100)	(11,850)
Taxable profit	<hr/> 8,925	<hr/> 6,740
Current tax expense at 40%	<hr/> 3,570	
Current tax expense at 35%		<hr/> <hr/> 2,359

INCOME TAXES

**Carrying amounts of property, plant and equipment**

<i>Cost</i>	<i>Building</i>	<i>Motor vehicles</i>	<i>Total</i>
Balance at 31/12/X4	50,000	10,000	60,000
Additions X5	6,000	-	6,000
	<hr/>	<hr/>	<hr/>
Balance at 31/12/X5	56,000	10,000	66,000
Elimination of accumulated depreciation on revaluation at 1/1/X6	(22,800)	-	(22,800)
Revaluation at 1/1/X6	31,800	-	31,800
	<hr/>	<hr/>	<hr/>
Balance at 1/1/X6	65,000	10,000	75,000
Additions X6	-	15,000	15,000
	<hr/>	<hr/>	<hr/>
	65,000	25,000	90,000
	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>
 <i>Accumulated depreciation</i>	 5%	 20%	
Balance at 31/12/X4	20,000	4,000	24,000
Depreciation X5	2,800	2,000	4,800
	<hr/>	<hr/>	<hr/>
Balance at 31/12/X5	22,800	6,000	28,800
Revaluation at 1/1/X6	(22,800)	-	(22,800)
	<hr/>	<hr/>	<hr/>
Balance at 1/1/X6	-	6,000	6,000
Depreciation X6	3,250	5,000	8,250
	<hr/>	<hr/>	<hr/>
Balance at 31/12/X6	3,250	11,000	14,250
	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>
 <i>Carrying amount</i>			
31/12/X4	30,000	6,000	36,000
	<hr/>	<hr/>	<hr/>
31/12/X5	33,200	4,000	37,200
	<hr/>	<hr/>	<hr/>
31/12/X6	61,750	14,000	75,750
	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>

INCOME TAXES

**Tax base of property, plant and equipment**

<i>Cost</i>	<i>Building</i>	<i>Motor vehicles</i>	<i>Total</i>
Balance at 31/12/X4	50,000	10,000	60,000
Additions X5	6,000	-	6,000
	<hr/>	<hr/>	<hr/>
Balance at 31/12/X5	56,000	10,000	66,000
Additions X6	-	15,000	15,000
	<hr/>	<hr/>	<hr/>
Balance at 31/12/X6	56,000	25,000	81,000
	<hr/>	<hr/>	<hr/>
<i>Accumulated depreciation</i>	10%	25%	
Balance at 31/12/X4	40,000	5,000	45,000
Depreciation X5	5,600	2,500	8,100
	<hr/>	<hr/>	<hr/>
Balance at 31/12/X5	45,600	7,500	53,100
Depreciation X6	5,600	6,250	11,850
	<hr/>	<hr/>	<hr/>
Balance 31/12/X6	51,200	13,750	64,950
	<hr/>	<hr/>	<hr/>
<i>Tax Base</i>			
31/12/X4	10,000	5,000	15,000
	<hr/>	<hr/>	<hr/>
31/12/X5	10,400	2,500	12,900
	<hr/>	<hr/>	<hr/>
31/12/X6	4,800	11,250	16,050
	<hr/>	<hr/>	<hr/>



INCOME TAXES

**Deferred tax assets, liabilities and expense at 31/12/X4**

	<i>Carrying amount</i>	<i>Tax base</i>	<i>Temporary differences</i>
Accounts receivable	500	500	-
Inventory	2,000	2,000	-
Product development costs	500	-	500
Investments	33,000	33,000	-
Property, plant & equipment	36,000	15,000	21,000
<b>TOTAL ASSETS</b>	<b>72,000</b>	<b>50,500</b>	<b>21,500</b>
Current income taxes payable	3,000	3,000	-
Accounts payable	500	500	-
Fines payable	-	-	-
Liability for healthcare benefits	-	-	-
Long-term debt	20,000	20,000	-
Deferred income taxes	8,600	8,600	-
<b>TOTAL LIABILITIES</b>	<b>32,100</b>	<b>32,100</b>	
Share capital	5,000	5,000	-
Revaluation surplus	-	-	-
Retained earnings	34,900	13,400	
<b>TOTAL LIABILITIES / EQUITY</b>	<b>72,000</b>	<b>50,500</b>	
<b>TEMPORARY DIFFERENCES</b>			<b>21,500</b>
Deferred tax liability	21,500 at 40%		8,600
Deferred tax asset	-	-	-
<b>Net deferred tax liability</b>			<b>8,600</b>

INCOME TAXES

**Deferred tax assets, liabilities and expense at 31/12/X5**

	<i>Carrying amount</i>	<i>Tax base</i>	<i>Temporary differences</i>
Accounts receivable	500	500	-
Inventory	2,000	2,000	-
Product development costs	250	-	250
Investments	33,000	33,000	-
Property, plant & equipment	37,200	12,900	24,300
<b>TOTAL ASSETS</b>	<b>72,950</b>	<b>48,400</b>	<b>24,550</b>
Current income taxes payable	3,570	3,570	-
Accounts payable	500	500	-
Fines payable	700	700	-
Liability for healthcare benefits	2,000	-	(2,000)
Long-term debt	12,475	12,475	-
Deferred income taxes	9,020	9,020	-
<b>TOTAL LIABILITIES</b>	<b>28,265</b>	<b>26,265</b>	<b>(2,000)</b>
Share capital	5,000	5,000	-
Revaluation surplus	-	-	-
Retained earnings	39,685	17,135	
<b>TOTAL LIABILITIES / EQUITY</b>	<b>72,950</b>	<b>48,400</b>	
<b>TEMPORARY DIFFERENCES</b>			<b>22,550</b>
Deferred tax liability	24,550 at 40%		9,820
Deferred tax asset	2,000 at 40%		(800)
Net deferred tax liability			9,020
Less: Opening deferred tax liability			(8,600)
Deferred tax expense (income) related to the origination and reversal of temporary differences			420

INCOME TAXES

**Deferred tax assets, liabilities and expense at 31/12/X6**

	<i>Carrying amount</i>	<i>Tax base</i>	<i>Temporary differences</i>
Accounts receivable	500	500	-
Inventory	2,000	2,000	-
Product development costs	-	-	-
Investments	33,000	33,000	-
Property, plant & equipment	75,750	16,050	59,700
<b>TOTAL ASSETS</b>	<u>111,250</u>	<u>51,550</u>	<u>59,700</u>
Current income taxes payable	2,359	2,359	-
Accounts payable	500	500	-
Fines payable	700	700	-
Liability for healthcare benefits	3,000	-	(3,000)
Long-term debt	12,805	12,805	-
Deferred income taxes	19,845	19,845	-
<b>TOTAL LIABILITIES</b>	<u>39,209</u>	<u>36,209</u>	<u>(3,000)</u>
Share capital	5,000	5,000	-
Revaluation surplus	19,637	-	-
Retained earnings	47,404	10,341	-
<b>TOTAL LIABILITIES / EQUITY</b>	<u>111,250</u>	<u>51,550</u>	<u>59,700</u>
<b>TEMPORARY DIFFERENCES</b>			<u>56,700</u>
Deferred tax liability	59,700 at 35%		20,895
Deferred tax asset	3,000 at 35%		(1,050)
Net deferred tax liability			<u>19,845</u>
Less: Opening deferred tax liability			(9,020)
Adjustment to opening deferred tax liability resulting from reduction in tax rate	22,550 at 5%		1,127
Deferred tax attributable to revaluation surplus	31,800 at 35%		(11,130)
Deferred tax expense (income) related to the origination and reversal of temporary differences			<u>822</u>

## INCOME TAXES

### Illustrative disclosure

The amounts to be disclosed in accordance with the Standard are as follows:

#### Major components of tax expense (income) (paragraph 79)

	X5	X6
Current tax expense	3,570	2,359
Deferred tax expense relating to the origination and reversal of temporary differences:	420	822
Deferred tax expense (income) resulting from reduction in tax rate	-	(1,127)
Tax expense	3,990	2,054

#### Income tax relating to the components of other comprehensive income (paragraph 81(ab))

Deferred tax relating to revaluation of building	-	(11,130)
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In addition, deferred tax of 557 was transferred in X6 from retained earnings to revaluation surplus. This relates to the difference between the actual depreciation on the building and equivalent depreciation based on the cost of the building.

#### Explanation of the relationship between tax expense and accounting profit (paragraph 81(c))

The Standard permits two alternative methods of explaining the relationship between tax expense (income) and accounting profit. Both of these formats are illustrated on the next page.

INCOME TAXES

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

	X5	X6
Accounting profit	8,775	8,740
	<u>3,510</u>	<u>3,059</u>
Tax at the applicable tax rate of 35% (X5: 40%)		
 Tax effect of expenses that are not deductible in determining taxable profit:		
Charitable donations	200	122
Fines for environmental pollution	280	-
Reduction in opening deferred taxes resulting from reduction in tax rate	-	(1,127)
Tax expense	<u>3,990</u>	<u>2,054</u>

The applicable tax rate is the aggregate of the national income tax rate of 30% (X5: 35%) and the local income tax rate of 5%.

- (ii) a numerical reconciliation between the average effective tax rate and the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed

	X5	X6
	%	%
Applicable tax rate	<u>40.0</u>	<u>35.0</u>
Tax effect of expenses that are not deductible for tax purposes:		
Charitable donations	2.3	1.4
Fines for environmental pollution	3.2	-
Effect on opening deferred taxes of reduction in tax rate	-	(12.9)
Average effective tax rate (tax expense divided by profit before tax)	<u>45.5</u>	<u>23.5</u>

## INCOME TAXES

The applicable tax rate is the aggregate of the national income tax rate of 30% (X5: 35%) and the local income tax rate of 5%.

**An explanation of changes in the applicable tax rate(s) compared to the previous accounting period (paragraph 81(d))**

In X6, the government enacted a change in the national income tax rate from 35% to 30%.

**In respect of each type of temporary difference, and in respect of each type of unused tax losses and unused tax credits:**

- (i) the amount of the deferred tax assets and liabilities recognised in the statement of financial position for each period presented;
- (ii) the amount of the deferred tax income or expense recognised in profit or loss for each period presented, if this is not apparent from the changes in the amounts recognised in the statement of financial position (paragraph 81(g))

	X5	X6
Accelerated depreciation for tax purposes	9,720	10,322
Liabilities for healthcare benefits that are deducted for tax purposes only when paid	(800)	(1,050)
Product development costs deducted from taxable profit in earlier years	100	-
Revaluation, net of related depreciation	-	10,573
Deferred tax liability	9,020	19,845
	9,020	19,845

*(note: the amount of the deferred tax income or expense recognised in profit or loss for the current year is apparent from the changes in the amounts recognised in the statement of financial position)*

### Example 3 – Business combinations

On 1 January X5 entity A acquired 100 per cent of the shares of entity B at a cost of 600. At the acquisition date, the tax base in A's tax jurisdiction of A's investment in B is 600. 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 B were to dispose of its underlying business. The tax rate in A's tax jurisdiction is 30 per cent and the tax rate in B's tax jurisdiction is 40 per cent.

The fair value of the identifiable assets acquired and liabilities assumed (excluding deferred tax assets and liabilities) by A is set out in the following table, together with their tax bases in B's tax jurisdiction and the resulting temporary differences.

	<i>Amounts recognised at acquisition</i>	<i>Tax base</i>	<i>Temporary differences</i>
Property, plant and equipment	270	155	115
Accounts receivable	210	210	-
Inventory	174	124	50
Retirement benefit obligations	(30)	-	(30)
Accounts payable	(120)	(120)	-
Identifiable assets acquired and liabilities assumed, excluding deferred tax	504	369	135

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 74 of the Standard).

No deduction is available in B's tax jurisdiction for the cost of the goodwill. Therefore, the tax base of the goodwill in B's jurisdiction is nil. However, in accordance with paragraph 15(a) of the Standard, A recognises no deferred tax liability for the taxable temporary difference associated with the goodwill in B's tax jurisdiction.

The carrying amount, in A's consolidated financial statements, of its investment in B is made up as follows:

Fair value of identifiable assets acquired and liabilities assumed, excluding deferred tax	504
Deferred tax liability (135 at 40%)	(54)
Fair value of identifiable assets acquired and liabilities assumed	450
Goodwill	150
Carrying amount	600

Because, at the acquisition date, the tax base in A's tax jurisdiction of A's investment in B is 600, no temporary difference is associated in A's tax jurisdiction with the investment.

During X5, B's equity (incorporating the fair value adjustments made as a result of the business combination) changed as follows:

INCOME TAXES

At 1 January X5	450
Retained profit for X5 (net profit of 150, less dividend payable of 80)	70
At 31 December X5	520

A recognises a liability for any withholding tax or other taxes that it will incur on the accrued dividend receivable of 80.

At 31 December X5, the carrying amount of A's underlying investment in B, excluding the accrued dividend receivable, is as follows:

Net assets of B	520
Goodwill	150
Carrying amount	670

The temporary difference associated with A's underlying investment is 70. This amount is equal to the cumulative retained profit since the acquisition date.

If A has determined that it will not sell the investment in the foreseeable future and that B will not distribute its retained profits in the foreseeable future, no deferred tax liability is recognised in relation to A's investment in B (see paragraphs 39 and 40 of the Standard). Note that this exception would apply for an investment in an associate only if there is an agreement requiring that the profits of the associate will not be distributed in the foreseeable future (see paragraph 42 of the Standard). A discloses the amount of the temporary difference for which no deferred tax is recognised: ie 70 (see paragraph 81(f) of the Standard).

If A expects to sell the investment in B, or that B will distribute its retained profits in the foreseeable future, A recognises a deferred tax liability to the extent that the temporary difference is expected to reverse. The tax rate reflects the manner in which A expects to recover the carrying amount of its investment (see paragraph 51 of the Standard). A recognises the deferred tax in other comprehensive income to the extent that the deferred tax results from foreign exchange translation differences that have been recognised in other comprehensive income (paragraph 61A of the Standard). A discloses separately:

- (a) the amount of deferred tax that has been recognised in other comprehensive income (paragraph 81(ab) of the Standard); and
- (b) the amount of any remaining temporary difference which is not expected to reverse in the foreseeable future and for which, therefore, no deferred tax is recognised (see paragraph 81(f) of the Standard).



## Example 4 - Compound financial instruments

An entity receives a non-interest-bearing convertible loan of 1,000 on 31 December X4 repayable at par on 1 January X8. In accordance with IAS 32 *Financial Instruments: Presentation*, the entity classifies the instrument's liability component as a liability and the equity component as equity. The entity assigns an initial carrying amount of 751 to the liability component of the convertible loan and 249 to the equity component. Subsequently, the entity recognises imputed discount as interest expense at an annual rate of 10% on the carrying amount of the liability component at the beginning of the year. The tax authorities do not allow the entity to claim any deduction for the imputed discount on the liability component of the convertible loan. The tax rate is 40%.

The temporary differences associated with the liability component and the resulting deferred tax liability and deferred tax expense and income are as follows:

	Year			
	X4	X5	X6	X7
Carrying amount of liability component	751	826	909	1,000
Tax base	<u>1,000</u>	<u>1,000</u>	<u>1,000</u>	<u>1,000</u>
Taxable temporary difference	<u>249</u>	<u>174</u>	<u>91</u>	<u>-</u>
Opening deferred tax liability at 40%	0	100	70	37
Deferred tax charged to equity	100	-	-	-
Deferred tax expense (income)	<u>-</u>	<u>(30)</u>	<u>(33)</u>	<u>(37)</u>
Closing deferred tax liability at 40%	<u>100</u>	<u>70</u>	<u>37</u>	<u>-</u>

As explained in paragraph 23 of the Standard, at 31 December X4, the entity recognises the resulting deferred tax liability by adjusting the initial carrying amount of the equity component of the convertible liability. Therefore, the amounts recognised at that date are as follows:

Liability component	751
Deferred tax liability	100
Equity component (249 less 100)	<u>149</u>
	<u>1,000</u>

Subsequent changes in the deferred tax liability are recognised in profit or loss as tax income (see paragraph 23 of the Standard). Therefore, the entity's profit or loss includes the following:

	Year			
	X4	X5	X6	X7
Interest expense (imputed discount)	-	75	83	91
Deferred tax expense (income)	<u>-</u>	<u>(30)</u>	<u>(33)</u>	<u>(37)</u>
	<u>-</u>	<u>45</u>	<u>50</u>	<u>54</u>

## Example 5 - Share-based payment transactions

In accordance with IFRS 2 *Share-based Payment*, an entity has recognised an expense for the consumption of employee services received as consideration for share options granted. A tax deduction will not arise until the options are exercised, and the deduction is based on the options' intrinsic value at exercise date.

As explained in paragraph 68B of the Standard, the difference between the tax base of the employee services received to date (being the amount the taxation authorities will permit as a deduction in future periods in respect of those services), and the carrying amount of nil, is a deductible temporary difference that results in a deferred tax asset. Paragraph 68B requires that, if the amount the taxation authorities will permit as a deduction in future periods is not known at the end of the period, it should be estimated, based on information available at the end of the period. If the amount that the taxation authorities will permit as a deduction in future periods is dependent upon the entity's share price at a future date, the measurement of the deductible temporary difference should be based on the entity's share price at the end of the period. Therefore, in this example, the estimated future tax deduction (and hence the measurement of the deferred tax asset) should be based on the options' intrinsic value at the end of the period.

As explained in paragraph 68C of the Standard, if the tax deduction (or estimated future tax deduction) exceeds the amount of the related cumulative remuneration expense, this indicates that the tax deduction relates not only to remuneration expense but also to an equity item. In this situation, paragraph 68C requires that the excess of the associated current or deferred tax should be recognised directly in equity.

The entity's tax rate is 40 per cent. The options were granted at the start of year 1, vested at the end of year 3 and were exercised at the end of year 5. Details of the expense recognised for employee services received and consumed in each accounting period, the number of options outstanding at each year-end, and the intrinsic value of the options at each year-end, are as follows:

	Employee services expense	Number of options at year-end	Intrinsic value per option
Year 1	188,000	50,000	5
Year 2	185,000	45,000	8
Year 3	190,000	40,000	13
Year 4	0	40,000	17
Year 5	0	40,000	20

The entity recognises a deferred tax asset and deferred tax income in years 1-4 and current tax income in year 5 as follows. In years 4 and 5, some of the deferred and current tax income is recognised directly in equity, because the estimated (and actual) tax deduction exceeds the cumulative remuneration expense.

## INCOME TAXES

### Year 1

Deferred tax asset and deferred tax income:

$$(50,000 \times 5 \times 1/3^{(a)} \times 0.40) = \underline{33,333}$$

<sup>(a)</sup>The tax base 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 base of the employee services received in year 1.

The deferred tax income is all recognised in profit or loss, because the estimated future tax deduction of 83,333 ( $50,000 \times 5 \times 1/3$ ) is less than the cumulative remuneration expense of 188,000.

### Year 2

Deferred tax asset at year-end:

$$(45,000 \times 8 \times 2/3 \times 0.40) = 96,000$$

$$\text{Less deferred tax asset at start of year} \quad \underline{(33,333)}$$

$$\text{Deferred tax income for year} \quad \underline{62,667^*}$$

\*This amount consists of the following:

Deferred tax income for the temporary difference between the tax base of the employee services received during the year and their carrying amount of nil:

$$(45,000 \times 8 \times 1/3 \times 0.40) \quad 48,000$$

Tax income resulting from an adjustment to the tax base of employee services received in previous years:

(a)	increase in intrinsic value: ( $45,000 \times 3 \times 1/3 \times 0.40$ )	18,000
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(b)	decrease in number of options: ( $5,000 \times 5 \times 1/3 \times 0.40$ )	<u>(3,333)</u>
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$$\text{Deferred tax income for year} \quad \underline{62,667}$$

The deferred tax income is all recognised in profit or loss, because the estimated future tax deduction of 240,000 ( $45,000 \times 8 \times 2/3$ ) is less than the cumulative remuneration expense of 373,000 (188,000 + 185,000).

### Year 3

Deferred tax asset at year-end:

$$(40,000 \times 13 \times 0.40) = 208,000$$

$$\text{Less deferred tax asset at start of year} \quad \underline{(96,000)}$$

$$\text{Deferred tax income for year} \quad \underline{112,000}$$

The deferred tax income is all recognised in profit or loss, because the estimated future tax deduction of 520,000 ( $40,000 \times 13$ ) is less than the cumulative remuneration expense of 563,000 (188,000 + 185,000 + 190,000).

INCOME TAXES

Year 4

Deferred tax asset at year-end: (40,000 × 17 × 0.40) =	272,000	
Less deferred tax asset at start of year	<u>(208,000)</u>	
Deferred tax income for year		<u>64,000</u>

The deferred tax income is recognised partly in profit or loss and partly directly in equity as follows:

Estimated future tax deduction (40,000 × 17) =	680,000	
Cumulative remuneration expense	<u>563,000</u>	
Excess tax deduction		<u>117,000</u>
Deferred tax income for year	64,000	
Excess recognised directly in equity (117,000 × 0.40) =	<u>46,800</u>	
Recognised in profit or loss		<u>17,200</u>

Year 5

Deferred tax expense (reversal of deferred tax asset)	272,000	
Amount recognised directly in equity (reversal of cumulative deferred tax income recognised directly in equity)	<u>46,800</u>	
Amount recognised in profit or loss		<u>225,200</u>
Current tax income based on intrinsic value of options at exercise date (40,000 × 20 × 0.40) =	320,000	
Amount recognised in profit or loss (563,000 × 0.40) =	<u>225,200</u>	
Amount recognised directly in equity		<u>94,800</u>

INCOME TAXES

*Summary*

	Statement of comprehensive income				Statement of financial position	
	Employee services expense	Current tax expense (income)	Deferred tax expense (income)	Total tax expense (income)	Equity	Deferred tax asset
Year 1	188,000	0	(33,333)	(33,333)	0	33,333
Year 2	185,000	0	(62,667)	(62,667)	0	96,000
Year 3	190,000	0	(112,000)	(112,000)	0	208,000
Year 4	0	0	(17,200)	(17,200)	(46,800)	272,000
Year 5	0	(225,200)	225,200	0	46,800	0
					(94,800)	
Totals	563,000	(225,200)	0	(225,200)	(94,800)	0

## Example 6 – Replacement awards in a business combination

On 1 January 20X1 Entity A acquired 100 per cent of Entity B. Entity A pays cash consideration of CU400 to the former owners of Entity B.

At the acquisition date Entity B had outstanding employee share options with a market-based measure of CU100. The share options were fully vested. As part of the business combination Entity B's outstanding share options are replaced by share options of Entity A (replacement awards) with a market-based measure of CU100 and an intrinsic value of CU80. The replacement awards are fully vested. In accordance with paragraphs B56–B62 of IFRS 3 *Business Combinations* (as revised in 2008), the replacement awards are part of the consideration transferred for Entity B. A tax deduction for the replacement awards will not arise until the options are exercised. The tax deduction will be based on the share options' intrinsic value at that date. Entity A's tax rate is 40 per cent. Entity A recognises a deferred tax asset of CU32 (CU80 intrinsic value × 40%) on the replacement awards at the acquisition date.

Entity A measures the identifiable net assets obtained in the business combination (excluding deferred tax assets and liabilities) at CU450. The tax base of the identifiable net assets obtained is CU300. Entity A recognises a deferred tax liability of CU60 ((CU450 – CU300) × 40%) on the identifiable net assets at the acquisition date.

Goodwill is calculated as follows:

	<b>CU</b>
Cash consideration	400
Market-based measure of replacement awards	100
<b>Total consideration transferred</b>	<b>500</b>
Identifiable net assets, excluding deferred tax assets and liabilities	(450)
Deferred tax asset	(32)
Deferred tax liability	60
<b>Goodwill</b>	<b>78</b>

Reductions in the carrying amount of goodwill are not deductible for tax purposes. In accordance with paragraph 15(a) of the Standard, Entity A recognises no deferred tax liability for the taxable temporary difference associated with the goodwill recognised in the business combination.

The accounting entry for the business combination is as follows:

	<b>CU</b>	<b>CU</b>
Dr Goodwill	78	
Dr Identifiable net assets	450	
Dr Deferred tax asset	32	
Cr Cash		400
Cr Equity (replacement awards)		100
Cr Deferred tax liability		60

On 31 December 20X1 the intrinsic value of the replacement awards is CU120. Entity A recognises a deferred tax asset of CU48 (CU120 × 40%). Entity A recognises deferred tax income of CU16 (CU48 – CU32) from the increase in the intrinsic value of the replacement awards. The accounting entry is as follows:

	<b>CU</b>	<b>CU</b>
Dr Deferred tax asset	16	
Cr Deferred tax income		16

If the replacement awards had not been tax-deductible under current tax law, Entity A would not have recognised a deferred tax asset on the acquisition date. Entity A would have accounted for any subsequent events that result in a tax deduction related to the replacement award in the deferred tax income or expense of the period in which the subsequent event occurred.

Paragraphs B56–B62 of IFRS 3 provide guidance on determining which portion of a replacement award is part of the consideration transferred in a business combination and which portion is attributable to future service and thus a post-combination remuneration expense. Deferred tax assets and liabilities on replacement awards that are post-combination expenses are accounted for in accordance with the general principles as illustrated in Example 5.

## **Example 7—Debt instruments measured at fair value**

### **Debt instruments**

At 31 December 20X1, Entity Z holds a portfolio of three debt instruments:

<b>Debt Instrument</b>	<b>Cost (CU)</b>	<b>Fair value (CU)</b>	<b>Contractual interest rate</b>
<b>A</b>	2,000,000	1,942,857	2.00%
<b>B</b>	750,000	778,571	9.00%
<b>C</b>	2,000,000	1,961,905	3.00%

Entity Z acquired all the debt instruments on issuance for their nominal value. The terms of the debt instruments require the issuer to pay the nominal value of the debt instruments on their maturity on 31 December 20X2.

Interest is paid at the end of each year at the contractually fixed rate, which equalled the market interest rate when the debt instruments were acquired. At the end of 20X1, the market interest rate is 5 per cent, which has caused the fair value of Debt Instruments A and C to fall below their cost and the fair value of Debt Instrument B to rise above its cost. It is probable that Entity Z will receive all the contractual cash flows if it continues to hold the debt instruments.

At the end of 20X1, Entity Z expects that it will recover the carrying amounts of Debt Instruments A and B through use, ie by continuing to hold them and collecting contractual cash flows, and Debt Instrument C by sale at the beginning of 20X2 for its fair value on 31 December 20X1. It is assumed that no other tax planning opportunity is available to Entity Z that would enable it to sell Debt Instrument B to generate a capital gain against which it could offset the capital loss arising from selling Debt Instrument C.

The debt instruments are measured at fair value through other comprehensive income in accordance with IFRS 9 *Financial Instruments* (or IAS 39 *Financial Instruments: Recognition and Measurement*<sup>1</sup>).

<sup>1</sup> IFRS 9 replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.

## Tax law

The tax base of the debt instruments is cost, which tax law allows to be offset either on maturity when principal is paid or against the sale proceeds when the debt instruments are sold. Tax law specifies that gains (losses) on the debt instruments are taxable (deductible) only when realised.

Tax law distinguishes ordinary gains and losses from capital gains and losses. Ordinary losses can be offset against both ordinary gains and capital gains. Capital losses can only be offset against capital gains. Capital losses can be carried forward for 5 years and ordinary losses can be carried forward for 20 years.

Ordinary gains are taxed at 30 per cent and capital gains are taxed at 10 per cent.

Tax law classifies interest income from the debt instruments as 'ordinary' and gains and losses arising on the sale of the debt instruments as 'capital'. Losses that arise if the issuer of the debt instrument fails to pay the principal on maturity are classified as ordinary by tax law.

## General

On 31 December 20X1, Entity Z has, from other sources, taxable temporary differences of CU50,000 and deductible temporary differences of CU430,000, which will reverse in ordinary taxable profit (or ordinary tax loss) in 20X2.

At the end of 20X1, it is probable that Entity Z will report to the tax authorities an ordinary tax loss of CU200,000 for the year 20X2. This tax loss includes all taxable economic benefits and tax deductions for which temporary differences exist on 31 December 20X1 and that are classified as ordinary by tax law. These amounts contribute equally to the loss for the period according to tax law.

Entity Z has no capital gains against which it can utilise capital losses arising in the years 20X1–20X2.

Except for the information given in the previous paragraphs, there is no further information that is relevant to Entity Z's accounting for deferred taxes in the period 20X1–20X2.

## Temporary differences

At the end of 20X1, Entity Z identifies the following temporary differences:

	Carrying amount (CU)	Tax base (CU)	Taxable temporary differences (CU)	Deductible temporary differences (CU)
Debt Instrument A	1,942,857	2,000,000		57,143
Debt Instrument B	778,571	750,000	28,571	
Debt Instrument C	1,961,905	2,000,000		38,095
Other sources	Not specified		50,000	430,000

The difference between the carrying amount of an asset or liability and its tax base gives rise to a deductible (taxable) temporary difference (see paragraphs 20 and 26(d) of the Standard). This is because deductible (taxable) temporary differences are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base, which will result in amounts that are deductible (taxable) in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled (see paragraph 5 of the Standard).



## Utilisation of deductible temporary differences

With some exceptions, deferred tax assets arising from deductible temporary differences are recognised to the extent that sufficient future taxable profit will be available against which the deductible temporary differences are utilised (see paragraph 24 of the Standard).

Paragraphs 28–29 of IAS 12 identify the sources of taxable profits against which an entity can utilise deductible temporary differences. They include:

- (a) future reversal of existing taxable temporary differences;
- (b) taxable profit in future periods; and
- (c) tax planning opportunities.

The deductible temporary difference that arises from Debt Instrument C is assessed separately for utilisation. This is because tax law classifies the loss resulting from recovering the carrying amount of Debt Instrument C by sale as capital and allows capital losses to be offset only against capital gains (see paragraph 27A of the Standard).

The separate assessment results in not recognising a deferred tax asset for the deductible temporary difference that arises from Debt Instrument C because Entity Z has no source of taxable profit available that tax law classifies as capital.

In contrast, the deductible temporary difference that arises from Debt Instrument A and other sources are assessed for utilisation in combination with one another. This is because their related tax deductions would be classified as ordinary by tax law.

The tax deductions represented by the deductible temporary differences related to Debt Instrument A are classified as ordinary because the tax law classifies the effect on taxable profit (tax loss) from deducting the tax base on maturity as ordinary.

In assessing the utilisation of deductible temporary differences on 31 December 20X1, the following two steps are performed by Entity Z.

### Step 1: Utilisation of deductible temporary differences because of the reversal of taxable temporary differences (see paragraph 28 of the Standard)

Entity Z first assesses the availability of taxable temporary differences as follows:

	(CU)
Expected reversal of deductible temporary differences in 20X2	
From Debt Instrument A	57,143
From other sources	430,000
Total reversal of deductible temporary differences	487,143
Expected reversal of taxable temporary differences in 20X2	
From Debt Instrument B	(28,571)
From other sources	(50,000)
Total reversal of taxable temporary differences	(78,571)
Utilisation because of the reversal of taxable temporary differences (Step 1)	78,571
Remaining deductible temporary differences to be assessed for utilisation in Step 2 (487,143 – 78,571)	408,572

In Step 1, Entity Z can recognise a deferred tax asset in relation to a deductible temporary difference of CU78,571.

## Step 2: Utilisation of deductible temporary differences because of future taxable profit (see paragraph 29(a) of the Standard)

In this step, Entity Z assesses the availability of future taxable profit as follows:

	(CU)
Probable future tax profit (loss) in 20X2 (upon which income taxes are payable (recoverable))	(200,000)
Add back: reversal of deductible temporary differences expected to reverse in 20X2	487,143
Less: reversal of taxable temporary differences (utilised in Step 1)	(78,571)
<b>Probable taxable profit excluding tax deductions for assessing utilisation of deductible temporary differences in 20X2</b>	<b>208,572</b>
Remaining deductible temporary differences to be assessed for utilisation from Step 1	408,572
<b>Utilisation because of future taxable profit (Step 2)</b>	<b>208,572</b>
Utilisation because of the reversal of taxable temporary differences (Step 1)	78,571
<b>Total utilisation of deductible temporary differences</b>	<b>287,143</b>

The tax loss of CU200,000 includes the taxable economic benefit of CU2 million from the collection of the principal of Debt Instrument A and the equivalent tax deduction, because it is probable that Entity Z will recover the debt instrument for more than its carrying amount (see paragraph 29A of the Standard).

The utilisation of deductible temporary differences is not, however, assessed against probable future taxable profit for a period upon which income taxes are payable (see paragraph 5 of the Standard). Instead, the utilisation of deductible temporary differences is assessed against probable future taxable profit that excludes tax deductions resulting from the reversal of deductible temporary differences (see paragraph 29(a) of the Standard). Assessing the utilisation of deductible temporary differences against probable future taxable profits without excluding those deductions would lead to double counting the deductible temporary differences in that assessment.

In Step 2, Entity Z determines that it can recognise a deferred tax asset in relation to a future taxable profit, excluding tax deductions resulting from the reversal of deductible temporary differences, of CU208,572. Consequently, the total utilisation of deductible temporary differences amounts to CU287,143 (CU78,571 (Step 1) + CU208,572 (Step 2)).

## Measurement of deferred tax assets and deferred tax liabilities

Entity Z presents the following deferred tax assets and deferred tax liabilities in its financial statements on 31 December 20X1:

	(CU)
Total taxable temporary differences	78,571
Total utilisation of deductible temporary differences	287,143
Deferred tax liabilities (78,571 at 30%)	23,571
Deferred tax assets (287,143 at 30%)	86,143

The deferred tax assets and the deferred tax liabilities are measured using the tax rate for ordinary gains of 30 per cent, in accordance with the expected manner of recovery (settlement) of the underlying assets (liabilities) (see paragraph 51 of the Standard).

## Allocation of changes in deferred tax assets between profit or loss and other comprehensive income

Changes in deferred tax that arise from items that are recognised in profit or loss are recognised in profit or loss (see paragraph 58 of the Standard). Changes in deferred tax that arise from items that are recognised in other comprehensive income are recognised in other comprehensive income (see paragraph 61A of the Standard).

Entity Z did not recognise deferred tax assets for all of its deductible temporary differences at 31 December 20X1, and according to tax law all the tax deductions represented by the deductible temporary differences contribute equally to the tax loss for the period. Consequently, the assessment of the utilisation of deductible temporary differences does not specify whether the taxable profits are utilised for deferred tax items that are recognised in profit or loss (ie the deductible temporary differences from other sources) or whether instead the taxable profits are utilised for deferred tax items that are recognised in other comprehensive income (ie the deductible temporary differences related to debt instruments classified as fair value through other comprehensive income).

For such situations, paragraph 63 of the Standard requires the changes in deferred taxes to be allocated to profit or loss and other comprehensive income on a reasonable pro rata basis or by another method that achieves a more appropriate allocation in the circumstances.