# Comments on «Making deferred taxes relevant»

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# Authors' recommendations

- Distinguish between tax-first differences (those that «start» by affecting taxable income) and book-first differences (those that «start» by affecting accounting profit).
  - Based on findings in some academic contributions, especially Laux (2013).
  - The definitions are not clear; ex. a depreciable asset normally starts depreciation in the same period, but with different amounts.
  - The alleged difference in future cash tax effects is also not clear.
- Partial allocation based on probability of tax cash flows.
- Present value measurement.

# Definition of «book-first» / «tax-first»

P 43 (proposed model)

should only be applied to temporary differences that are first included in the financial statements and only thereafter in the tax return (Book-First). These deferred tax assets and deferred tax liabilities will result in future tax cash flows, whereas this is not the case for temporary differences from the balance sheet approach that are first included in the tax return and then in the financial statements (Tax-First). This proposal for Book-First temporary differences has

P. 32 (referring to litterature)

- Temporary differences that arise because transactions and/or events are first brought into the financial statements and then in the tax return (*Book-First temporary differences*)
- Temporary differences that arise because transactions and/or events are first brought into the tax return and then in the financial statements (*Tax-First temporary differences*).

In practice, the examples of tax-first are depreciable fixed assets with tax depreciation allowances that are more front-loaded than accounting depreciation.

# Cash effects of a «tax-first» case

A machine is purchased for 100 beginning of year 1; it generates cash revenue of 100 each of year 1 & 2.
100 % tax depr year 1; 100 % book depr year 2.

| | Year 1 | Year 2 |
|---|---|---|
| Acquisition | 100 | 0 |
| Revenue | 100 | 100 |
| Book depreciation | 0 | 100 |
| Tax depreciation | 100 | 0 |
| Profit before tax | 100 | 0 |
| Taxable income | 0 | 100 |
| Current tax expense | 0 | 20 |
| Taxable temporary diff | 100 | 0 |
| Deferred tax liability | 20 | 0 |
| Deferred tax expense | 20 | -20 |

«Tax first»

CTE = cash tax payments

My proposition: The sequence of its origins has no importance for whether the DT item represents future cash.

# Non-deductible goodwill (p. 49)

- Purchase non-deductible goodwill (BV 1000, tax base 0) => temp diff 1000.
- IAS 12 goodwill exception => no DTL.
- Authors’ proposal: remove (redundant) exception; tax cash flows (linked to non-deductible goodwill) are not probable => no DTL.
- Contrary view: goodwill represents future earnings expectations = taxable income => tax cash flows.

# Could the proposal for depreciable assets (Ex. 4 p. 46) still work?

| | Entity A under IAS 12 | | | | Entity A under new approach | | | |
|---|---|---|---|---|---|---|---|---|
| **Year** | **PP&E** | **TVA PP&E** | **DTL** | **Net result** | **PP&E** | **TVA PP&E** | **DTA** | **Net result** |
| **0** | 1,000 | - | - | - | 1,000 | (190) | 190 | - |
| **1** | 900 | - | (25) | 675 | 900 | (171) | 158 | 687 |
| **2** | 800 | - | (50) | 675 | 800 | (152) | 124 | 685 |
| **3** | 700 | - | (75) | 675 | 700 | (133) | 86 | 683 |
| **4** | 600 | - | (100) | 675 | 600 | (114) | 45 | 681 |
| **5** | 500 | - | (125) | 675 | 500 | (95) | - | 669 |
| **6** | 400 | - | (100) | 675 | 400 | (76) | - | 669 |
| **7** | 300 | - | (75) | 675 | 300 | (57) | - | 669 |
| **8** | 200 | - | (50) | 675 | 200 | (38) | - | 669 |
| **9** | 100 | - | (25) | 675 | 100 | (19) | - | 669 |
| **10** | - | - | - | 675 | - | - | - | 669 |

- Why should cash effects from the deductions be the only ones reflected?
- Is the profile of the tax expense (= revenue 1000 – net result) improved?

# My recommendations

- Fully agree that efforts to improve IAS 12 should be continued.
- Value relevance of DTL & DTA is not a useful guidance for reforming the standard; value relevance of the tax expense (that includes the DTE) vs. the CTE alone, would be useful.
  - After all, tax laws and tax analysis are about flows, not stocks.
- The absolute discounting prohibition should be removed.
  - But mandatory discounting is not advisable; the examples used in the paper (depreciations) have a given cash flow profile; this is generally not case.
  - Lack of discounting future estimated tax cash flows leads to overstatement of DTL in business combinations => inflating goodwill.
- Make IAS 12 more principles-based; objective to give a tax expense that reflect the activities of the period.