

STAFF PAPER

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Project	Income Tax		
Paper topic	Case Study		
CONTACT(S)	Mitsuhiro Takemura	mtakemura@ifrs.org	+81 3 5205 7282

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Introduction

1. The IASB staff have prepared the following case study as additional information for the income tax discussions that will be held at today's CMAC meeting. The case study is intended to provide the CMAC members with more detailed information and examples about the issues that the staff believe may potentially require a fundamental change in income tax accounting (under IAS 12 *Income Taxes*) today. The main possible changes relate to: (1) discounting of deferred tax balances and (2) deferred taxes arising from revaluation. This case study also includes examples of the financial effects of applying different approaches to accounting for income taxes to the same fact pattern.

Case Study—Effect of tax law change in depreciation

2. In the 2010 Budget, New Zealand's government made the following changes in tax law effective from the tax year ending 30 June 2012:
 - (a) corporate tax rate reduced from 30 per cent to 28 per cent; and
 - (b) the tax depreciation on buildings with estimated useful life of 50 years or more was eliminated.
3. Some New Zealand companies had previously recorded a deferred tax liability resulting from the difference between the tax depreciation and accounting depreciation on the buildings. Because of the tax law changes above, these companies reported, in accordance with IAS 12:

- (a) a gain from the decrease in deferred tax liability, due to the anticipated decrease in tax rate from 30 per cent to 28 per cent; and
 - (b) a loss from the increase in deferred tax liability, due to the elimination of tax depreciation for long-lived buildings.
4. Some stakeholders disagreed with the usefulness of the information produced in accordance with IAS 12 under these circumstances, because:
- (a) buildings are long-lived assets for which the tax effect would be realised over 50 years, yet the deferred tax liability **does not reflect time value of money (Questions 1–2)**; and
 - (b) if a building is measured at **fair value**, the effect of disallowing the tax deduction from building depreciation has already been taken into account in the computation of its fair value. It would be **double counting of tax effects** if a deferred tax liability is separately recognised while the building is measured at fair value (**Questions 3–4**).
5. Following are examples of disclosures regarding the tax law change in New Zealand.
6. The company's accounting policy for property, plant and equipment was to recognise those assets at **historical costs less accumulated depreciation (ie, a Cost Model)**. In the notes to the financial statements, the company reported the impact of the change in corporate tax rate and the impact of the removal of tax depreciation on buildings on a group base as follows:

	2010	2009
Profit before income tax	1,040,000	800,000
Tax on that profit at 30 per cent	312,000	240,000
Plus/(less) tax effect of adjustments:		
Impact of change in corporate income tax rate	(213,000)	0
Removal of tax depreciation on buildings (note 1)	174,000	0
Other differences	1,000	(2,000)
Tax credit	(3,000)	0
income tax (over) provided in prior year	(3,000)	(16,000)
Income tax expense	268,000	222,000
Comprising:		
Current tax	221,000	188,000
Deferred tax	47,000	34,000
	268,000	222,000

Staff note 1: the impact of removing the tax depreciation on buildings (28 per cent of the depreciable amount) is recognised as tax expense immediately when the tax law is changed. Deferred tax is recognised for all temporary differences.

7. If different approaches were taken to accounting for income tax, the company would have reported deferred tax differently. The following are what the staff think the tax reconciliation disclosure would be if different approaches¹ were taken to accounting for income tax. Please note that the IASB has not discussed those approaches yet:

(a) Flow-through approach

No deferred tax is recognised because, under this approach, only current tax (amounts due to the tax authority) is recognised. As a result, the reconciliation would show all adjustments (permanent differences and timing differences) from book net income to taxable profit.

¹ Derived from EFRAG Discussion Paper on Income Tax in 2011.

	2010	2009
Profit before income tax	1,040,000	800,000
Tax on that profit at 30%	312,000	240,000
Plus/(less) tax effect of adjustments:		
Impact of timing differences	123,520	(34,000)
Impact of change in corporate income tax rate	(213,000)	0
Non-deductible depreciation on building (note 2)	3,480	0
Other differences	1,000	(2,000)
Tax credit	(3,000)	0
income tax (over) provided in prior year	(3,000)	(16,000)
Income tax expense	221,000	188,000
Comprising:		
Current tax	221,000	188,000
	221,000	188,000

Staff note 2: under this approach, the impact of removal of tax depreciation is recognised as tax expense over the economic life of building (174,000/50 years=3,480). No deferred tax is recognised.

(b) Accrual/timing difference approach

No deferred tax is recognised for the removal of tax depreciation on buildings, because the removal of tax depreciation on a building would not create a timing difference. It would however be reported as a permanent difference over the economic life of the buildings.

	2010	2009
Profit before income tax	1,040,000	800,000
Tax on that profit at 30%	312,000	240,000
Plus/(less) tax effect of adjustments:		
Impact of change in corporate income tax rate	(213,000)	0
Non-deductible depreciation on buildings (note 3)	3,480	0
Other differences	1,000	(2,000)
Tax credit	(3,000)	0
income tax (over) provided in prior year	(3,000)	(16,000)
Income tax expense	97,480	222,000
Comprising:		
Current tax	221,000	188,000
Deferred tax	(123,520)	34,000
	97,480	222,000

Staff note 3: under this approach, the impact of removal of tax depreciation is recognised as tax expense over the economic life of the building (174,000/50 years=3,480). Deferred tax is recognised for all timing differences.

(c) Partial allocation approach

The result depends on other recurring items that would offset the impact of the tax law change. In below table, the staff assumed that only 50 per cent of the impact of timing differences would have an impact on the future tax payment.

	2010	2009
Profit before income tax	1,040,000	800,000
Tax on that profit at 30%	312,000	240,000
Plus/(less) tax effect of adjustments:		
Impact of change in corporate income tax rate	(213,000)	0
Tax effect of timing differences not recognised (note 4)	61,760	0
Non-deductible depreciation on buildings (note 4)	3,480	0
Other differences	1,000	(2,000)
Tax credit	(3,000)	0
Income tax (over) provided in prior year	(3,000)	(16,000)
Income tax expense	159,240	222,000
Comprising:		
Current tax	221,000	188,000
Deferred tax (note 4)	(61,760)	34,000
	159,240	222,000

Staff note 4: under this approach, the impact of removal of tax depreciation is recognised as tax expense over the economic life of building ($174,000/50$ years= $3,480$). Deferred tax is recognised only in part (assume 50%) of the timing differences ($123,520 \times 50\% = 61,760$).

(d) Valuation adjustment approach

There would be no change in the presentation in the table from the temporary difference approach above, because it is merely a change in presentation in the balance sheet. Under this approach, buildings would be presented as follows:

		Property, Plant and Buildings CU000
<i>Cost - Service</i>		
Balance as at 1 July 2009		14,830,000
Additions		263,000
Transfers from work in progress		364,000
Disposals		(35)
Balance as at 30 June 2010		15,456,965
<i>Cost - Tax benefit</i>		
Balance as at 1 July 2009		6,356,000
Additions		113,000
Transfers from work in progress		156,000
Disposals		(15)
Removal of tax depreciation on buildings		(174,000)
Balance as at 30 June 2010		6,450,985
<i>Depreciation and impairment losses</i>		
Balance as at 1 July 2009		(2,012,000)
Depreciation charge		(490,000)
Disposals		35
Balance as at 30 June 2010		(2,501,965)
<i>Tax Relief (note 5)</i>		
Balance as at 1 July 2009		(862,000)
Tax Relief		(490,000)
Disposals		15
Balance as at 30 June 2010		(1,351,985)

Items to consider: usefulness of results under current approach and alternative approaches

Which way of disclosing a tax reconciliation do CMAC members think is most useful for your analysis?

Items to consider: should the impact be discounted?

If you prefer to recognise the impact of the removal of tax depreciation when tax law is changed , do you think the impact of the removal of tax depreciation on building should be discounted to reflect the fact that it would be realised over the economic life of buildings (eg 50 years)?

8. Assume the company chose to **revalue those assets at fair value** regularly (ie the **Revaluation Model**) under IAS 16 *Property, Plant and Equipment* and disclosed the amount of buildings and deferred tax as follows:

Property, Plant and Equipment

	Buildings	
	Cost Model CU000	Revaluation Model CU000
Beginning balance as at 1 July 2008	181,000	181,000
Reclassification	99,000	99,000
Additions	33,000	33,000
Transfers to capital work in progress	1,000	1,000
Disposal	(4,000)	(4,000)
Revaluation at fair value (note 6)		6,000
Balance as at 30 June 2009	310,000	316,000
Beginning balance as at 1 July 2009	310,000	316,000
Additions	5,000	5,000
Transfers to capital work in progress	1,000	1,000
Disposal	0	0
Revaluation at fair value (note 6)	0	9,000
Balance as at 30 June 2010	316,000	331,000

Staff note 6: the fair value of the building is computed using the discounted cash flow method, taking into account the future rental income and the income tax on that rental income.

9. In a very simplified case, the fair value of the building is computed as shown below:

	Year 1	Year 2	Year 3	...	Year 49	Year 50
Rental income	25,000	25,000	25,020	...	26,000	26,000
Admin expenses	-2,000	-2,000	-2,010	...	-2,500	-2,500
Tax depreciation	0	0	0	...	0	0
Tax (@28%)	-6,440	-6,440	-6,443	...	-6,580	-6,580
Net cash inflow	16,560	16,560	16,567	...	16,920	16,920

NPV@5% 331,000
The figures are expressed in CU000

10. There are some criticisms over the current accounting result to recognising a deferred tax liability for revaluation gain. Some think that the fair value of buildings has already taken into account the tax effect of future rental income and the disallowing of tax depreciation on buildings. Those critics think that it would be **double counting the same tax effect if a deferred tax liability were to be separately recognised**. The consequences of this 'double counting'

effect is that reported shareholders' equity ends up being lower (higher) than otherwise would be the case, which can then lead to **distortions to commonly used metrics such as Return on Equity or Return on Capital.**

Items to consider: double counting of tax effect when the asset is measured at fair value

Do CMAC members believe that, in the case above, the tax effect of disallowing depreciation on buildings is already reflected in the fair value, and thus it would be double counting the tax effect if a deferred tax liability were to be recognised separately?