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STAFF PAPER

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Project	**IAS 12 *Income Taxes* research project**
Paper topic	Appendix A: Various Accounting Models for Income Taxes

CONTACTS	Grace Leung	gleung@ifrs.org	+81 3 5205-7288
	Mitsuhiro Takemura	mtakemura@ifrs.org	+81 3 5205-7282

Appendix A: Explanation of various accounting models for income taxes

1. The staff studied a number of discussion papers or research papers produced by national standard-setters or academics and noted that the following approaches are always discussed as an alternative approach to the accounting for income taxes:

    (a) the current tax approach (also known as the ‘flow through approach’ or ‘tax payable approach’);

    (b) the timing difference approach (also known as the ‘income approach’);

        (i) Deferral method vs Liability method

        (ii) Comprehensive allocation vs Partial allocation

        (iii) Accruals approach;

    (c) the balance sheet liability approach (also known as the ‘temporary difference approach’); and

    (d) the valuation adjustment approach (also known as the ‘net of tax approach’).

Current tax approach (or 'Flow through approach' or 'Tax payable approach')

2. Under this approach, only the current tax assessed on profit of the current period is recognised in the financial statements. Most proponents of this approach agree that deferred tax information needs to be disclosed in the footnotes.

3. Supporters of this approach question whether a deferred tax liability meets the definitions of a liability under the *Conceptual Framework*. On the other hand, opponents of this approach think that all or some deferred tax liabilities meet the definition of a liability.

Timing difference approach (or 'Income approach ')

4. Under this approach, deferred tax is recognised for timing differences, but not permanent differences. Timing differences are differences between taxable profit and accounting profit that originate in one period and reverse in one or more subsequent periods. Permanent differences are differences between taxable profit and accounting profit that originate in one period and do not reverse in subsequent periods.

5. There are two methods under the timing difference approach. They have different objectives and result in different measurements.

   (a) Deferral method

   (i) The objective of the deferral method is to match the tax expense with the underlying related income and expenses so that they are recognised in the same period. If current tax effects lead to timing differences that originate in the current period and will reverse in the future, those current tax effects are deferred until the reversal occurs. (These differences are sometimes called 'tax before book' differences.) Conversely, if current tax effects will arise in future periods, on the reversal of timing differences that originated in the current period, those current tax effects are recognised in the period when the timing difference originates. (These differences are sometimes called ‘book before tax’ differences.)

(ii) The tax effects of timing differences originating in the current period are measured using the current tax rate. The tax effects of timing differences that reverse in the current period are generally measured using the tax rates that applied when the timing difference originated. Deferred tax balances in the balance sheet (statement of financial position) are *not* adjusted to reflect changes in the tax rate or the imposition of new taxes

(b) Liability method

(i) The objective of the liability method is to recognise as assets and liabilities those tax balances that meet the definition of, and the recognition criteria for, assets and liabilities in the *Conceptual Framework*.

(ii) The expected future tax effects of timing differences are reported as liabilities for taxes payable in the future, or as assets arising from advance payment of future taxes or for the recovery of past taxes. Those tax effects are measured at the tax rates applied when the timing difference is expected to reverse. Deferred tax balances in the balance sheet are adjusted to reflect changes in the tax rate or the imposition of new taxes.

6. Under the timing difference/ income approach, the tax effect of all timing differences is generally recognised as a deferred tax liability or a deferred tax asset (ie **Comprehensive Allocation**). However, in a variation of this approach, the tax effect is recognised for only some timing differences (ie **Partial Allocation**).

Partial Allocation method

7. Under this approach, no deferred tax is recognised for those timing differences that are not expected to reverse.

8. Those who support the partial allocation method usually argue that some timing differences are replaced, as they reverse, by new timing differences and are, therefore, in the nature of permanent differences.

9. Those who oppose partial allocation argue that it is no more justifiable than failing to recognise accounts payable if they will be replaced, when they are paid, by new accounts payable.

Accruals approach

10. In 2011, the European Financial Reporting Advisory Group (EFRAG) published a discussion paper, *Improving the Financial Reporting of Income Tax*, in which it described the accruals approach as follows:[1]

    (a) Under this approach the reported tax expense reflects the tax effect of all transactions and events that are reported in the period. No formal distinction is required between amounts that form part of the current tax assessment and those that affect future tax assessments, although, if tax effects are discounted, the amount of more distant tax effects will be smaller.

    (b) The accruals approach is essentially the same as a ‘timing difference approach’ which is usually described as requiring the reported tax expense to be the sum of the tax assessed on the income of the current period and the tax effect of timing differences. This characterisation, however, does not make it clear that the same principle is applied to all items of income and expense.

    (c) The accruals approach differs from the temporary difference approach in that some temporary differences (such as those arising on the initial recognition in a business combination of an asset at an amount in excess of its tax basis) are not timing differences, and accordingly no tax effect is recognised for such items.

[1] According to the 2013 EFRAG Feedback Statement on the discussion paper, the accruals approach was the most supported alternative method for tax accounting if a fundamental change is considered necessary.

Balance sheet liability approach (or 'temporary difference approach')

11. The balance sheet liability approach is the approach that a number of accounting standards in the world, including IAS 12 and US GAAP Topic 740 *Income Taxes*, use today.

12. Under this approach, deferred tax liabilities and deferred tax assets are recognised for temporary differences. Temporary differences are differences between the carrying amount of an asset or liability and its tax base (for example, for an asset, the tax base is the amount deductible for tax purposes). All timing differences are temporary differences but some temporary differences are not timing differences. Examples of the latter include temporary differences that arise when:
    (a) long-term assets are not deductible in determining taxable profit;
    (b) assets and liabilities are acquired in a business combination; and
    (c) goodwill is not amortised for tax purposes.

13. Because the balance sheet liability approach focusses on identifying assets and liabilities, the liability method used in the income approach generally fits the rationale for that approach better than the deferral method does. Consequently, tax effects are measured at the tax rates that will apply when the carrying amount of an asset (or liability) is expected to be recovered (or settled). Deferred tax balances in the balance sheet are adjusted to reflect changes in the tax rate or the imposition of new taxes.

14. In applying the balance sheet liability approach, both comprehensive allocation and partial allocation might be possible. Comprehensive application is used in IAS 12 and US GAAP Topic 740.

Valuation adjustment approach (or 'net-of-tax approach')

15. This approach is based on the premise that timing differences (or temporary differences) do not give rise to deferred tax assets or deferred tax liabilities but they affect instead the carrying amount of underlying assets or liabilities.

16. With this view, an asset provides two distinct streams of benefits, namely (a) the potential to provide service and (b) the right to tax benefits (tax deduction). For example, when accelerated depreciation is claimed for tax purposes, the right to

receive tax benefits is consumed more quickly than the asset's potential to provide service. Consequently, when the entity consumes some of the right to receive tax benefits, the entity should reflect that consumption by reducing the carrying amount of the underlying asset, rather than by recognising a separate deferred tax liability.

17. Supporters of this approach argue that it reflects more faithfully the economics of owning a tax-deductible asset, because the management should be willing to pay a higher price for an asset that provides a tax deduction than for an asset for which the consumption cannot be deducted (or has already been deducted) for tax purposes.

18. Under this approach, tax benefits that are reflected in the amount of an asset are measured at the tax rates applicable when the tax benefits are expected to be realised. If the tax rate changes, or if new taxes are imposed, the carrying amount of the asset may need to be adjusted (this would depend to some extent on the measurement basis used for the asset).

19. Some versions of a valuation adjustment approach may use a valuation adjustment approach for some types of timing difference or temporary difference (for example, for some tax before book differences) and recognise a separate deferred tax liability or deferred tax asset for some others (for example, for some book before tax differences).