

INCOME TAX

Draft flow chart and illustrative examples

prepared by the IASB's staff

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The following flow chart and illustrative examples have been prepared by the IASB's staff to illustrate the proposals in the IASB's exposure draft *Income Tax*, on which comments are invited by 31 July 2009. Subject to any views received on the exposure draft the staff intend to publish similar examples when the IASB issues the standard resulting from that exposure draft.

The IASB has not approved the following material.

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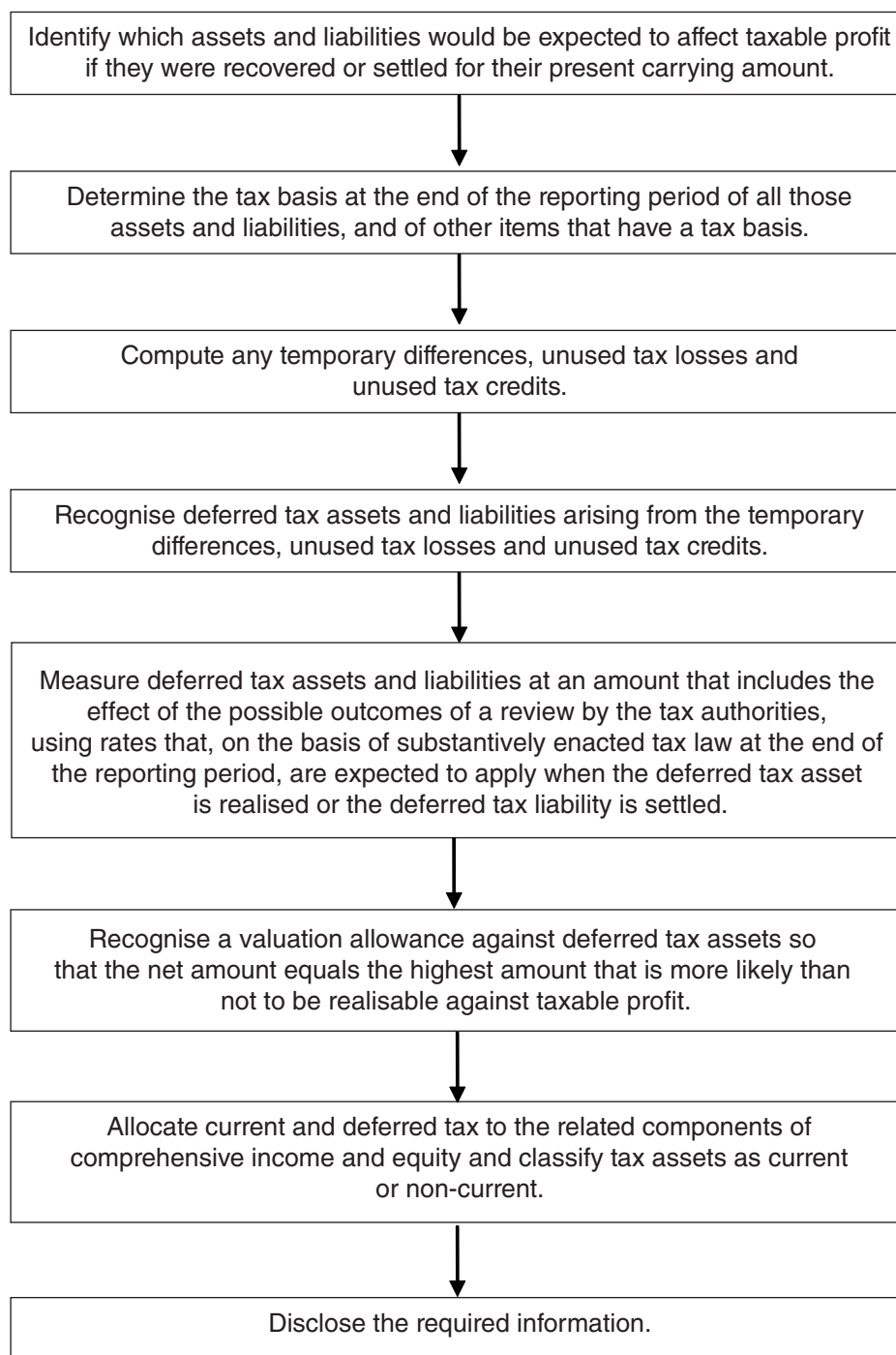
CONTENTS

Examples

COMPUTATION OF DEFERRED TAX LIABILITIES AND ASSETS	FLOW CHART
ASSETS AND LIABILITIES FOR WHICH THE RECOVERY OR SETTLEMENT IS NOT EXPECTED TO AFFECT TAXABLE PROFIT	1
TAX BASIS AND TEMPORARY DIFFERENCES	2–4
CALCULATION OF TEMPORARY DIFFERENCE ON THE INITIAL RECOGNITION OF ASSETS AND LIABILITIES, AND SUBSEQUENT CHANGES	
Outside a business combination and affecting equity	5–6
Outside a business combination and not affecting comprehensive income, equity or taxable profit	7–10
As part of a business combination	11–13
ASSETS AND LIABILITIES REMEASURED AT FAIR VALUE	14–15
TAX RATES	16–17
UNCERTAINTY WHETHER THE TAX AUTHORITIES WILL ACCEPT THE AMOUNTS REPORTED TO THEM BY THE ENTITY	18
ALLOCATION OF TAX	19–21
DISCLOSURE OF TAX RECONCILIATION	22

Computation of deferred tax liabilities and assets

Paragraph 5 of the [draft] IFRS summarises the steps involved in accounting for deferred tax liabilities and assets. They are set out in the following flow chart.



Assets and liabilities for which the recovery or settlement is not expected to affect taxable profit

Paragraph 10 of the [draft] IFRS states that if the entity expects to recover the carrying amount of an asset or settle the carrying amount of a liability without affecting taxable profit, no deferred tax arises in respect of the asset or liability. The following example illustrates such assets and liabilities.

Example 1

- 1 An entity accrues fines and penalties. They are not deductible for tax purposes.
The settlement of the liability does not affect taxable profit so no deferred tax arises.
- 2 An entity owns an investment property that is measured in accordance with the fair value model in IAS 40 *Investment Property* and would not be depreciated if it were accounted for in accordance with IAS 16 *Property, Plant and Equipment*. No tax is payable or recoverable on the proceeds of sale.

In accordance with paragraph B30, the entity expects to recover the carrying amount of the asset through sale. No deferred tax asset or liability arises in respect of the investment property.

Tax basis and temporary differences

Tax basis is defined as the measurement, under applicable substantively enacted existing tax law, of an asset, liability or other item. Paragraph 15 of the [draft] IFRS specifies that

- (a) the tax basis of an asset equals the amount that would have been deductible against taxable income in arriving at taxable profit if the carrying amount of the asset had been recovered through sale at the end of the reporting period. If the recovery of the asset through sale does not give rise to taxable income, the tax basis shall be deemed to be equal to the carrying amount.
- (b) the tax basis of a liability equals its carrying amount less any amounts deductible against taxable income (or plus any amounts included in taxable income) that would have arisen if the liability had been settled for its carrying amount at the end of the reporting period. In the case of deferred revenue, the tax basis of the resulting liability is its carrying amount, less any amount of revenue that will not be taxable in future periods.

Paragraph 17 of the [draft] IFRS states that temporary differences arise:

- (a) when there is a difference between the carrying amounts and tax bases of assets and liabilities on the initial recognition, or at the time the tax basis is created for those items that have a tax basis but are not recognised as assets and liabilities.
- (b) when a difference between the carrying amount and tax basis arises after initial recognition because income or expense is recognised in comprehensive income or equity in one reporting period but is recognised in taxable profit in a different period.
- (c) when the tax basis of an asset or liability changes and the change will not be recognised in the asset or liability's carrying amount in any period.

The following examples illustrate these requirements.

Example 2—Initial recognition of assets and liabilities

- 1 The liability component of a compound financial instrument (eg 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). If the liability were settled for its carrying amount, a taxable gain would arise equal to the difference between the carrying amount and the amount repayable on maturity. The tax basis of the liability is therefore equal to the amount repayable on maturity. (See example 6 below for a numerical example.)
- 2 An asset is recognised at fair value in a business combination and no equivalent adjustment is made for tax purposes. The tax basis of the asset is the same as it was before the business combination.

3 A liability is recognised at its fair value in a business combination and the related expense is deducted in determining taxable profit in a later period. If the liability is settled for its fair value, deductions equal to fair value would be available, so the tax basis is nil.

4 Goodwill is not deductible for tax purposes. Its tax basis is therefore nil. However, in accordance with paragraph 21 of the [draft] IFRS no deferred tax is recognised for this temporary difference.

Example 3—A difference between the carrying amount and tax basis arises after initial recognition because income or expense is recognised in comprehensive income or equity in one reporting period but is recognised in taxable profit in a different period

1 An entity purchases equipment and receives a tax deduction in the current period equal to the cost of the equipment. The tax basis of the equipment is nil.

2 An asset is depreciated faster or slower for tax purposes than in the financial statements. The tax basis is cost less the tax depreciation and will therefore differ from the carrying amount.

3 Deductions of 15 per cent of the cost of an asset are available in each of up to ten years if the asset is used in a particular way. Deductions of 10 per cent of cost are available in each of up to ten years if the asset is used in any other way. Deductions of cost are available on sale with deductions of 10 per cent previously claimed repayable.

The tax basis of the asset is cost less any 10 per cent deductions already received. So for example, if the asset cost CU100* and were used in the specified particular way for three years, the tax basis after three years would be CU70.

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.

The tax basis of the asset does not include the impairment.

5 Financial assets or investment property are remeasured at fair value but no equivalent adjustment is made for tax purposes.

The tax basis of the assets is equal to the initial tax basis, usually cost.

6 An entity makes a loan. No tax is payable on repayment of the principal amount or the proceeds of its sale.

The tax basis of the loan receivable is equal to its carrying amount and there is no temporary difference on initial recognition.

7 Interest revenue is received in arrears and is included in accounting profit or loss on an effective interest rate basis but is included in taxable profit on a cash basis. If the accrued interest were sold for its carrying amount, tax would be payable on the proceeds with no tax deductions.

The tax basis of the interest receivable is nil.

8 A loan payable was measured on initial recognition at fair value less transaction costs, and is measured subsequently at amortised cost. For tax purposes, the transaction costs were deducted when the loan was first recognised. If the loan were settled for its carrying amount, a taxable gain equal to the difference between the proceeds of the loan (the original fair value) and the amortised cost would arise.

The tax basis of the loan payable is the original fair value, so the temporary difference is the amount of transaction costs, less the cumulative amount amortised to accounting profit under the effective interest method.

9 Prepaid expenses have already been deducted on a cash basis in determining the taxable profit of the current or previous periods.

The tax basis of the prepaid expenses is nil.

* In this guidance monetary amounts are denominated in 'currency units (CU)'.

- 10 An entity recognises accrued expenses. The related expense will be deducted for tax purposes on a cash basis.
If the accrued expenses were settled for the carrying amount, tax deductions equal to the carrying amount would be available. The tax basis of the accrual is therefore nil.
- 11 An entity recognises accrued expenses. The recognised expense is deductible for tax purposes.
If the accrued expenses were settled for the carrying amount, no tax deductions would be available. The tax basis of the accrual is therefore equal to the carrying amount.
- 12 Pension costs are deducted in determining accounting profit or loss 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.
If the pension liability were settled for the carrying amount, tax deductions equal to the carrying amount would be available. The tax basis of the pension liability is therefore nil.
- 13 Research costs (or organisation or other start-up costs) are recognised as an expense in determining accounting profit or loss but are not permitted as a deduction in determining taxable profit until a later period.
The tax basis of the research costs equals the amount that will be available as a deduction against taxable profit in the future.
- 14 Development costs have been capitalised and will be amortised to profit or loss but were deducted in determining taxable profit in the period in which they were incurred.
The tax basis of the development cost asset is nil.
- 15 Revenue and the related cost of goods sold are included in accounting profit or loss when goods are delivered but are included in taxable profit when cash is collected.
This gives rise to:
(a) a temporary difference on the receivable (which has a tax basis of nil) and
(b) a temporary difference on the inventories sold (the inventory has a carrying amount of nil but still has the same tax basis as before the sale).
- 16 Unrealised profits or losses resulting from intragroup transfers of non-monetary assets are eliminated from the consolidated financial statements.
The tax basis of the non-monetary assets is determined by the tax jurisdiction into which they are transferred, and will usually be equal to the transfer price.
- 17 Retained earnings of subsidiaries, 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.
The tax basis of the investment in the subsidiary, associate or joint venture does not include the amounts included in the financial statement consolidated retained earnings.*
- 18 Investments in foreign subsidiaries or foreign joint ventures are affected by changes in foreign exchange rates.
The tax basis of the investments does not include the effect of the changes in foreign exchange rates.
- 19 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.
The tax basis of the assets does not include the restatement.
- 20 Income is deferred in the statement of financial position but has already been included in taxable profit in the current period or prior periods.
The tax basis of the deferred revenue is nil.

* The exposure draft proposes an exception prohibiting the recognition of deferred tax assets and liabilities for some of these temporary differences relating to foreign subsidiaries and joint ventures.

Example 4—Changes in the tax basis of an asset or liability that will not be recognised in its carrying amount

- 1 An entity purchases an asset and receives no tax deductions in the current period. However, deductions equal to an indexed cost are available when the asset is sold. The tax basis of the asset is equal to indexed cost at each reporting date.
- 2 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. The tax basis of the assets and liabilities are translated into the functional currency and change as exchange rates change, resulting in temporary differences.

Calculation of temporary difference on the initial recognition of assets and liabilities, and subsequent changes

Paragraphs B10–B13 set out the requirements when a temporary difference arises on the initial recognition of an asset or liability. The following examples illustrate those requirements, and the recognition of subsequent changes.

Outside a business combination and affecting equity (paragraph B13(a))**Example 5—Deductions on an equity instrument**

An entity purchases an option on its own shares for CU100 and classifies it as an equity instrument. For tax purposes, the cost of the option will be deductible against future taxable profits at some point in the future (for example, when the option is exercised, or expires, or on redemption of the underlying instrument). The tax rate is 40 per cent.

The deductions form a tax basis of an item for which there is no asset or liability carrying amount. There is a temporary difference of CU100, which gives rise to a deferred tax asset of CU40. The entity recognises the effect of the deferred tax asset in equity. Dr equity 100, Cr cash 100 for the purchase of the option and Dr deferred tax asset 40, Cr equity to recognise the deferred tax asset.

Example 6—Compound financial instrument

An entity issues a non-interest-bearing convertible loan for CU1,000 on 31 December 20X4 repayable at par on 1 January 20X8. The tax authorities do not allow the entity to claim any deductions relating to repayment of CU1,000. In other words, the tax basis of the instrument as a whole is CU1,000. 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. Subsequently, the entity recognises imputed interest expense to increase the carrying amount of the loan to CU1,000 over the period to repayment. In other words, the financial instrument is accounted for as an interest-bearing liability and an equity option. If a market participant took out an interest-bearing liability, it would receive tax deductions for the interest. The tax rate is 40 per cent.

The fair value of the liability assuming the tax basis that would be available to market participants, ie assuming that the interest is tax-deductible, is CU751. The tax basis of the instrument as a whole is CU1,000. The resulting temporary differences, deferred tax liability and deferred tax income are as follows:

	20X4	20X5	20X6	20X7
	CU	CU	CU	CU
Carrying amount of liability component	751	826	909	1,000
Tax basis of liability component	1,000	1,000	1,000	1,000
Taxable temporary difference	249	174	91	–
Opening deferred tax liability at 40%	0	100	70	37
Deferred tax charged to equity	100	–	–	–
Deferred tax income	–	(30)	(33)	(37)
Closing deferred tax liability at 40%	100	70	37	–

INCOME TAX

The difference between the tax basis of the instrument and its carrying amount creates a temporary difference. A deferred tax liability is recognised. The debit side of the double entry is recognised in equity because the transaction that causes the temporary difference is the recognition of CU249 of the proceeds as an equity component.

Therefore, the amounts recognised at initial recognition are as follows:

	CU
Liability component	751
Deferred tax liability	100
Equity component (CU249 less CU100)	149
	<u>1,000</u>

Subsequent changes in the deferred tax liability are recognised in the income statement as tax income.

	20X4	20X5	20X6	20X7
	CU	CU	CU	CU
Interest expense (imputed discount)	–	75	83	91
Deferred tax income	<u>–</u>	<u>(30)</u>	<u>(33)</u>	<u>(37)</u>
	<u>–</u>	<u>45</u>	<u>50</u>	<u>54</u>

Outside a business combination and not affecting comprehensive income, equity or taxable profit (paragraph B13(c))

Example 7—Tax basis depends on cost to first owner

An entity acquires an industrial building for CU1,950. The building is depreciated on a straight-line basis over 20 years for financial reporting purposes. According to tax law, tax deductions of 4 per cent of the original cost to the first owner are available for 25 years against income generated from use of the asset. In other words, if the building is sold by one owner to another, the tax deductions associated with the asset are not the cost of the building to the subsequent owner, but the original cost less any tax deductions already received by previous owners. The entity pays tax of 30 per cent on taxable income.

The tax basis of the building is CU1,728 on acquisition, and all market participants would get the same tax basis. The original cost of the building was CU1,800 and the previous owner received tax deductions of CU72 before sale. The entity recognises the following for financial reporting purposes on initial recognition:

Dr Building	CU1,950
Dr Deferred tax liability—discount	CU67
Cr Deferred tax liability	CU67((CU1,950 – CU1,728) × 30%)
Cr Cash	CU1,950

The entity receives tax deductions of CU72 for each year of use. As a result, the tax basis of the asset reduces by CU72 annually. The difference between the carrying amount and the tax basis of the asset is a temporary difference because recovery of the carrying amount of the asset would result in taxable amounts. The discount on the deferred tax liability is recognised in profit or loss as the related tax is realised.

Example 8—Intangible assets with indefinite lives in a shell company where the tax consequences depend on whether the shares in the company are sold or whether the asset is used or sold as an individual asset

An entity acquires a shell company with a single asset, an internally generated brand for CU1,143. The entity treats the acquisition as an asset acquisition because there is no business associated with the acquired brand. Market participants acquiring such a brand as an individual asset would receive a tax basis equal to the cost of the brand. The fair value of the brand assuming such a tax basis is CU1,143. The brand is an intangible asset with an indefinite life carried at cost less impairment. Two years later, the recoverable amount of the brand is CU1,000 and the resulting impairment has been recognised.

According to tax law, if the shell company sells the brand as an individual asset, the shell company cannot deduct the cost of the brand taxable income (ie the tax basis of the brand is nil). Income or sales proceeds are taxable at 30 per cent. However, if the shares of the shell company are sold, a deduction equal to the cost of the shares is available to offset against sales proceeds. Capital gains (losses) generated on sale of the business are also taxable (deductible) at 30 per cent.

On initial recognition, the entity recognises the brand at the cost it would have if it had a tax basis equal to that available to market participants, ie CU1,143. The entity also recognises a deferred tax liability of CU343 ($CU1,143 - 0 \times 30\%$) arising from the difference between the carrying amount and the actual tax basis of nil. A premium is recognised for the difference between the carrying amounts of the recognised asset and tax liability and the cost of the brand. The following table shows the amounts before and after the impairment.

	On acquisition	After impairment	Gains/(losses)
	CU	CU	CU
Brand	1,143	1,000	(143)
Deferred tax liability related to the brand	(343)	(300)	43
Premium	343	300	(43)
Cost/recoverable amount	1,143	1,000	(143)

Example 9—Non-taxable government grant

A non-taxable government grant of CU40 related to an asset costing CU100 is deducted in arriving at the carrying amount of the asset in the financial statements but, for tax purposes, is not deducted from the tax basis. A market participant would have expected to pay CU100 for the asset and to obtain a tax basis equal to cost. The tax rate is 30 per cent.

The entity recognises the asset at CU100 less the grant of CU40, ie at CU60. There is a temporary difference of CU40, giving rise to a deferred tax asset of CU12. The entity recognises an allowance of CU12 so that the total amounts recognised equal the purchase consideration less the grant.

Alternatively, under IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* the government grant could be recognised as deferred income. In this case, the carrying amount of the asset and the tax basis are both CU100 and no temporary difference arises. However, there is a temporary difference between the carrying amount of the deferred income of CU40 and its tax basis of nil. Whichever method of presentation an entity adopts, the entity recognises a deferred tax asset and a purchase allowance.

Example 10—Finance lease

An entity enters into a finance lease. The tax authority gives deductions equal in amount and timing to the lease payments. If the entity acquired the asset, its tax basis would be equal to cost and if the entity took out a loan, the tax basis of the loan would equal the proceeds. The fair value of the asset assuming a tax basis equal to its cost is CU100. The tax rate is 30 per cent.

The entity recognises the asset and the lease liability at CU100. The tax basis of the asset is nil and the tax basis of the lease liability is nil. The entity recognises a deferred tax liability of CU30 for the temporary difference on the asset and a deferred tax asset of CU30 for the temporary difference on the lease liability. The net sum of the amounts recognised for the asset, lease liability, deferred tax asset and deferred tax liability equals nil, so no premium or allowance arises.

As part of a business combination (paragraph B13(b))**Example 11—Deferred tax assets and liabilities for identifiable net assets and the investment in the subsidiary**

On 1 January 20X5 entity A acquired 100 per cent of the shares of entity B at a cost of CU600. At the acquisition date the tax basis of A's investment in B is CU600. 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 following table sets out the fair value of the identifiable assets acquired and liabilities assumed (excluding deferred tax assets and liabilities) by A, together with their tax bases in B's tax jurisdiction and the resulting temporary differences.

	Amounts recognised at acquisition	Tax basis	Temporary differences
	CU	CU	CU
Property, plant and equipment	270	155	115
Accounts receivable	210	210	–
Inventory	174	124	50
Retirement benefit obligations	(30)	–	(30)
Accounts payable	(120)	(120)	–
Fair value of the identifiable assets acquired and liabilities assumed, excluding deferred tax	<u>504</u>	<u>369</u>	<u>135</u>

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 36 of the [draft] IFRS).

No deduction is available in B's tax jurisdiction for the cost of the goodwill. Therefore, the tax basis of the goodwill in B's jurisdiction is nil. However, paragraph 21 of the [draft] IFRS prohibits the recognition of a deferred tax liability on the initial recognition of goodwill.

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

	CU
Fair value of identifiable assets acquired and liabilities assumed, excluding deferred tax	504
Deferred tax liability (CU135 at 40%)	<u>(54)</u>
Fair value of identifiable assets acquired and liabilities assumed	450
Goodwill	<u>150</u>
Carrying amount	<u>600</u>

Because, at the acquisition date, the tax basis in A's tax jurisdiction, of A's investment in B is CU600, there is no temporary difference in A's tax jurisdiction for the investment.

INCOME TAX

During 20X5 B's equity (incorporating the fair value adjustments made as a result of the business combination) changed as follows:

	CU
At 1 January 20X5	450
Retained profit for 20X5 (net profit of CU150, less dividend payable of CU80)	70
At 31 December 20X5	<u>520</u>

A recognises a liability for any withholding tax or other taxes that it will incur on the accrued dividend receivable of CU80.

At 31 December 20X5 the carrying amount of A's underlying investment in B, excluding the accrued dividend receivable, is as follows:

	CU
Net assets of B	520
Goodwill	150
Carrying amount	<u>670</u>

The temporary difference associated with A's underlying investment is CU70. This amount is equal to the cumulative retained profit since the acquisition date.

Unless B is a foreign subsidiary and A's investment is essentially permanent in duration, A recognises a deferred tax liability for the temporary difference.

Example 12—Intangible asset with an indefinite life where the tax consequences are different depending on whether the asset is sold as part of a business, or used or sold as an individual asset

The fact pattern is the same as in example 8 except that the acquisition is regarded as a business combination. An entity acquires a subsidiary with an internally generated brand. Market participants acquiring such a brand as an individual asset would receive a tax basis equal to the cost of the brand. The fair value of the brand assuming such a tax basis is CU1,143. The brand is an intangible asset with an indefinite life and is carried at cost less impairment. At the end of year 2, the recoverable amount of the brand is CU1,000.

According to tax law, if the subsidiary sells the brand as an individual asset, the cost of the brand cannot be offset against taxable income (ie the tax basis of the brand is nil). Income or sales proceeds are taxable at 30 per cent. However, if the subsidiary is sold, a deduction of the cost of the business is available to offset against sales proceeds. Capital gains (losses) generated on sale of the business are also taxable (deductible) at 30 per cent.

On initial recognition, the brand would be recognised at fair value. A deferred tax liability of CU343 ($CU1,143 - 0 \times 30\%$) arising from the temporary difference would be recognised as part of the allocation of cost of the business combination to the identifiable assets and liabilities of the entity. There may also be an amount recognised in goodwill because the purchase price will reflect the possibility that the entity has of paying less tax by selling the brand as part of the business. The following tables show the simplified amounts that would result if the brand were the only asset and the amount that the entity paid for the subsidiary is determined on the assumption that the brand will be recovered through sale of the subsidiary.

	On acquisition	After impairment	Gains/ (losses)
	CU	CU	CU
Brand	1,143	1,000	(143)
Deferred tax liability related to the brand	(343)	(300)	43
Identifiable net assets of subsidiary	800	700	(100)

INCOME TAX

Goodwill	343	300	(43)
Carrying amount of subsidiary	1,143	1,000	(143)
Deferred tax asset related to the investment in the subsidiary	–	43 $((1,143 - 1,000) \times 0.3)$	43
Total	1,143	1,043	(100)

The deferred tax liability related to the brand is determined without reference to the possibility of recovering the brand through sale of the subsidiary. Next, it is necessary to consider whether there is a temporary difference relating to the investment in the subsidiary. In particular, in year 2, the carrying amount of the investment in the subsidiary reduces by CU143 because of the impairment of the brand. This may give rise to a temporary difference. If so, that would result, in total, in deferred tax income of CU86: CU43 from the impairment of the brand and CU43 from the reduction in the carrying amount of the subsidiary. In the above example, the amount originally recognised in goodwill reflected the entity's expectation of recovering the asset through the sale of the investment. Some of that amount is written off at the time of the impairment, offsetting some of the recognised tax benefit. In practice, any impairment of the goodwill will be determined in accordance with IAS 36 *Impairment of Assets* and may not have such a result.

Example 13—Replacement awards in a business combination

On 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 $\times$ 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) $\times$ 40%) on the identifiable net assets at the acquisition date.

The tax basis of A's investment in B is equal to the cash consideration of CU400. There is a temporary difference of CU100 compared with the carrying amount of CU500. Entity A recognises a deferred tax liability of CU40.

Goodwill is calculated as follows:

	CU
Cash consideration	400
Market-based measure of replacement awards	100
Total consideration transferred	500
Identifiable net assets, excluding deferred tax assets and liabilities	(450)
Deferred tax asset on replacement awards	(32)
Deferred tax liability on identifiable net assets	60
Deferred tax liability on investment in B	40
Goodwill	118

Reductions in the carrying amount of goodwill are not deductible for tax purposes. In accordance with paragraph 21 of the [draft] IFRS, Entity A recognises no deferred tax liability for the temporary difference associated with the goodwill recognised in the business combination.

INCOME TAX

The accounting entry for the business combination is as follows:

	CU	CU
Dr Goodwill	118	
Dr Identifiable net assets	450	
Dr Deferred tax asset	32	
Cr Cash		400
Cr Equity (replacement awards)		100
Cr Deferred tax liability		100

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

	CU	CU
Dr Deferred tax asset	16	
Cr Deferred tax income		16

If the replacement awards had not been tax deductible under substantively enacted tax law, Entity A would not have recognised a deferred tax asset on the acquisition date. If any subsequent events result in a tax deduction related to the replacement award, Entity A would account for them 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 employee benefit expense. Deferred tax assets and liabilities on the latter are accounted for in accordance with the general principles as illustrated in Example 21.

This example does not cover subsequent changes in the temporary difference on A's investment in B.

Assets and liabilities remeasured at fair value (paragraphs B14 and B15)

Example 14—Investment property when trading gains are taxable and capital gains are not taxable

An entity acquires real estate at a cost of CU1,000. The property is held for investment and carried at fair value with changes in fair value recognised in profit or loss in accordance with IAS 40.

The tax law states that rental income generated from real estate assets is taxed at 20 per cent. Tax depreciation of the real estate cannot be deducted against the rental income generated. For sales of real estate, the investor has a tax status of trading in real estate or not trading in real estate. If the tax authorities treat the investor as engaged in trading of real estate, any profits (losses) on sale of the real estate are subject to 20 per cent tax (tax relief). If the tax authorities treat the investor as not engaged in trading real estate, no capital gains tax is payable.

The tax basis of the real estate depends on whether the investor is engaged in trading real estate. The tax basis is determined by the tax status of the entity.

Scenario 1: Investor is engaged in trading of real estate

The tax basis of the real estate is CU1,000 (because CU1,000 of tax deductions would be available on the sale of the asset).

A temporary difference will arise when the carrying amount of the asset is remeasured to a fair value different from the tax basis of CU1,000. That basis difference is a temporary difference because the recovery of the carrying amount has tax consequences for the entity.

INCOME TAX

The amounts reported for financial reporting and tax purposes (ignoring income generated by the asset) are as follows:

Investment property	Initial	Year 1	Year 2	Year 3	Year 4
	CU	CU	CU	CU	CU
Carrying amount	1,000	1,050	1,150	1,100	900
Tax basis	1,000	1,000	1,000	1,000	1,000
Difference	0	50	150	100	(100)
Deferred tax asset (liability) @ 20%	0	(10)	(30)	(20)	20
Deferred tax expense	0	10	20	(10)	(40)
Income statement effect					
Fair value movements	0	(50)	(100)	50	200
Current tax	0	0	0	0	0
Deferred tax	0	10	20	(10)	(40)
	0	(40)	(80)	40	160
Effective tax rate		20%	20%	20%	20%

If the asset is sold, the deferred tax liability would be derecognised and would reduce the tax expense on any taxable gain.

If the investor expects to recover the asset through use (rental income), deferred tax would be recognised as shown above. At the end of its useful life, it is assumed that because a tax deduction is available upon sale, the investor would sell the asset for a nominal amount, thus generating a taxable loss that could be offset against other taxable income.

Scenario 2: The investor is not engaged in trading real estate

The tax basis is determined by the consequences of sale. No taxable gain or loss arises on sale so the tax basis always equals the carrying amount.

Example 15—tax is not payable on sales proceeds in excess of an asset's cost

An entity acquires an asset. If the asset is used, the income generated is taxable and tax deductions of 20 per cent of cost are available in each of the first five years of use. If the asset is sold, taxable income arises equal to the proceeds up to the original cost. No taxable income arises for proceeds in excess of the asset's original cost. Deductions are available against taxable income arising on sale of cost less deductions already received. The tax rate applicable to sale and use is 30 per cent. The asset is remeasured at fair value in accordance with IAS 16. The asset cost CU100 and has a carrying amount of CU150 after two years.

The tax basis after two years is CU60. The temporary difference is CU90. If the entity expects to recover the carrying amount of the asset through use, a deferred tax liability of CU27 ($\text{CU90} \times 30$ per cent) arises. If the entity expects to recover the carrying amount of the asset by sale, a tax rate of 30 per cent applies to the part of the temporary difference that relates to the original cost, ie CU40 ($\text{CU100} - \text{CU60}$) and a tax rate of nil applies to the remainder of the temporary difference. A deferred tax liability of CU12 ($\text{CU40} \times 30$ per cent) arises.

Tax rates (paragraph B29)

Paragraph B29 requires an entity to measure deferred tax assets and liabilities at the tax rate that is applicable to the sale, if the deductions underlying the tax basis are available only on sale. If the same deductions are also available for the use of the asset, paragraph B29 requires an entity to measure the deferred tax asset or liability at the rate that is applicable to the manner in which the entity expects to recover or settle the carrying amount of its asset or liability. The following examples illustrate this.

Example 16—Different deductions available on sale and use

An entity acquires an asset for CU100. Deductions of 150 per cent are available over ten years if the asset is used. If the asset is sold, deductions of 100 per cent of cost are available but all previous deductions received for use must be returned. The tax rate applicable to use is 30 per cent and the tax rate applicable to sale is 20 per cent. The entity expects to recover the carrying amount of the asset through use over ten years.

The tax basis of the asset is determined by the consequences of recovery through sale. After two years the carrying amount of the asset is CU80 and the tax basis is CU70 (CU100 less the deductions of CU30 already received). There is a temporary difference of CU10. The deductions available on use are not the same as the deductions available on sale, so the deferred tax liability is measured at the sale rate of 20 per cent.

Example 17—Same deductions available on sale and use

The cost of an asset of CU100 is deductible for tax purposes on a straight-line basis over ten years while the asset is being used. On sale, a deduction is available of cost less the tax depreciation previously received. A tax rate of 30 per cent applies to the income generated from the use of the assets and a tax rate of 25 per cent applies to the taxable profit on sale. The entity's financial reporting depreciation is based on an expected service life of 12 years and a residual value of CU40. The entity has used the asset for two years.

At the end of the second year the asset's depreciated carrying amount is CU90. The tax basis of the asset is cost less tax depreciation already received, ie CU80. This results in a temporary difference of CU10. The temporary difference will increase to CU50 until the end of the ten-year tax-deductible period and will reverse through use over the following two years back to CU40 with the balance reversing on the sale of the asset. The same deductions are available on recovery of the asset through sale and use. The entity therefore determines the rate that is applicable to the expected manner of recovery of the carrying amount. CU10 of the temporary difference reverses through use and is measured at 30 per cent and CU40 reverses through sale and is measured at 25 per cent.

Uncertainty whether the tax authorities will accept the amounts reported to them by the entity (paragraph 26)

Paragraph 26 of the [draft] IFRS requires an entity to measure current and deferred tax assets and liabilities using the probability-weighted average amount of all the possible outcomes, assuming that the tax authorities will review the amounts reported and have full knowledge of all relevant information. The following example illustrates this.

Example 18

An entity reports taxable profit of CU1,000 to the tax authority. The effect of uncertainty over the amounts reported is immaterial except in relation to two deductions. The entity assesses the possible outcomes of those deductions as follows:

Possible outcome	Probability of outcome occurring	Probability-weighted outcome
Deduction A (reported amount CU3,000)		
CU3,000	80%	CU2,400
CU0	20%	CU0
Probability-weighted average		CU2,400

Deduction B (reported amount CU900)		
CU900	60%	CU540
CU200	40%	CU80
Probability-weighted average		CU620

The entity measures its current tax liability based on taxable profit of CU1,880 (CU1,000 plus reported deductions of CU3,000 and CU900 less those deductions measured at CU2,400 and CU620).

Allocation of tax

Paragraph B34 requires an entity to recognise the tax benefit from a deferred tax asset in the same component of comprehensive income or equity as the event or transaction giving rise to the deferred tax asset. It also requires an entity to recognise the effect of a valuation allowance recognised at the same time as the deferred tax asset in that same component.

Paragraph B36(c) requires the entity to recognise a change in a valuation allowance as follows:

- (a) if income in the current year causes a reduction in the valuation allowance, in the component in which the income is recognised and
- (b) if a change in circumstances causes a change in judgement about the recoverability of deferred tax assets in future years, in continuing operations.

The following example illustrates these requirements.

Example 19—Allocation of tax benefits

An entity recognises profit of CU100 from continuing operations and a loss of CU150 in other comprehensive income (OCI). The tax rate is 30 per cent. CU100 of the CU150 loss can be offset against the profit from continuing operations in determining taxable profit. The remaining CU50 loss can be carried forward and utilised against future taxable profits. The entity assesses that it is more likely than not that there will not be sufficient taxable profits in the future and recognises a valuation allowance for the full amount of the deferred tax asset. The next year, the entity recognises a gain of CU20 in OCI that leads to taxable profit against which some of the loss carryforward can be used and which the entity had not expected in assessing the valuation allowance previously. The entity now reassesses the need for a valuation allowance and concludes that it is not needed because the entity expects further gains in OCI. The entity therefore recognises a tax benefit of CU15.

The allocation of the tax amounts is set out below.

	Year 1	Year 2
Continuing operations	100	0
Tax	(30)	9
Other comprehensive income	(150)	20
Tax in OCI	30	6

Example 20—Allocation of tax expense to components of comprehensive income other than continuing operations

Paragraph 34 sets out the requirements for allocating tax to components of comprehensive income if the sum of the separately calculated tax expenses allocated to each component in accordance with paragraphs 29–33 does not equal the total tax expense. This example illustrates those requirements.

Facts

An entity's statement of comprehensive income before recognising income tax is as follows:

	CU
Loss from continuing operations	(150)
Loss from discontinued operations	(400)
Other comprehensive income—actuarial gain on pension liability	25
Other comprehensive income—loss on available-for-sale security	(45)

The entity pays tax at 40 per cent. It has paid tax on taxable profit of CU100 in prior periods to which it can carry back losses. Its temporary differences at the beginning and end of the period are:

	Opening temporary difference/ loss carryforward CU	Closing temporary difference/ loss carryforward CU
Non-pension liabilities in continuing operations	100	50
Fixed assets in continuing operations	(300)	(200)
Operating loss carryforward from discontinued operations	—	400
Pension liabilities	25	—
Available-for-sale securities	75	120
Total	(100)	370
Deferred tax asset/liability before valuation allowance	(40)	148
Valuation allowance	—	(148) note 1
Net deferred tax (liability)/asset	(100)	—

Note 1—the entity does not expect taxable profit in the future beyond that created by the reversal of the temporary differences on the fixed assets. It therefore recognises a valuation allowance to reduce the net deferred tax asset to nil.

Calculation of total tax expense

The entity recognises total current tax income of CU40 resulting from the loss carryback of CU100.

The entity also recognises total deferred tax income of CU40 arising from the reduction in the deferred tax liability from CU100 to nil.

Allocation to continuing operations

The entity first calculates the tax that would have been recognised had there been only continuing operations during the period. In that case, the entity would have recognised current tax income of CU40 arising from the carryback of CU100 of the loss from continuing operations. There is no remaining current tax to allocate to other components.

INCOME TAX

The entity would also have the following temporary differences:

	Opening temporary difference CU	Closing temporary difference CU
Non-pension liabilities in continuing operations	100	50
Fixed assets in continuing operations	(300)	(200)
Discontinued operations	–	– [note 1]
Pension liabilities	25	25 [note 1]
Available-for-sale securities	75	75 [note 1]
Total	(100)	(50)
Deferred tax (liability)/asset before valuation allowance	(40)	(20)
Valuation allowance	–	–
Net deferred tax (liability)/asset	(40)	(20)

Note 1—This table ignores items recognised in the period outside continuing operations. The objective is to assess the tax effect for the period if no items were recognised outside continuing operations in the period. So, in the table, the temporary differences on items recognised outside continuing operations do not change during the period.

The deferred tax liability reduces over the period from CU40 to CU20 because of items recognised in continuing operations. The entity therefore recognises deferred tax income of CU20 in continuing operations.

That leaves deferred tax income of CU20 to be allocated to the items recognised outside profit or loss. The tax expense arising from each item is calculated as the difference between the total tax expense including the tax effect of the item and total tax expense excluding the tax effect of the item.

Tax expense arising from discontinued operations

The deferred tax expense excluding discontinued operations would arise from the following temporary differences:

	Opening temporary difference CU	Closing temporary difference CU
Non-pension liabilities in continuing operations	100	50
Fixed assets in continuing operations	(300)	(200)
Pension liabilities	25	–
Available-for-sale securities	75	120
Total	(100)	(30)
Deferred tax (liability)/asset before valuation allowance	(40)	(12)
Valuation allowance	–	–
Net deferred tax (liability)/asset	(40)	(12)

Excluding discontinued operations results in a deferred tax liability of CU12, rather than nil. The deferred tax income arising from discontinued operations is therefore CU12.

Tax expense arising from the change in pension liability recognised in other comprehensive income

The deferred tax expense excluding the effect of the change in pension liability recognised in OCI would arise from the following temporary differences:

	Opening temporary difference CU	Closing temporary difference CU
Non-pension liabilities in continuing operations	100	50
Fixed assets in continuing operations	(300)	(200)
Operating loss carryforward from discontinued operations	–	400
Pension liabilities	25	25
Available-for-sale securities	75	120
Total	(100)	395
Deferred tax (liability)/asset before valuation allowance	(40)	158
Valuation allowance	–	(158)
Net deferred tax (liability)/asset	(100)	–

Excluding the effect of the change in the pension liability recognised in OCI does not change the closing net deferred tax asset of nil. The deferred tax expense arising from the change in the pension liability recognised in OCI is therefore nil.

Tax expense arising from change in value of available-for-sale securities recognised in OCI

The deferred tax expense excluding the effect of the change in value of available-for-sale securities recognised in OCI would arise from the following temporary differences:

	Opening temporary difference CU	Closing temporary difference CU
Non-pension liabilities in continuing operations	100	50
Fixed assets in continuing operations	(300)	(200)
Operating loss carryforward from discontinued operations	–	400
Pension liabilities	25	–
Available-for-sale securities	75	75
Total	(100)	325
Deferred tax (liability)/asset before valuation allowance	(40)	130
Valuation allowance	–	(130)
Net deferred tax (liability)/asset	(100)	–

Excluding the effect of the change in the value of available-for-sale securities recognised in OCI does not change the closing net deferred tax asset of nil. The deferred tax expense arising from the change in the value of available-for-sale securities recognised in OCI is therefore nil.

Allocation of tax expense not allocated to continuing operations

The tax expense arising from the items recognised outside continuing operations in accordance with the previous calculations is as follows:

Discontinued operations	CU12
Changes in pension liability recognised in OCI	nil
Changes in value of available-for-sale securities recognised in OCI	nil

But the remaining tax expense to be recognised is CU20. That amount is allocated to the items recognised outside continuing operations pro rata to their individual tax effects. So, in this example it is allocated in full to discontinued operations.

Summary of allocation

	Current tax	Deferred tax	Total tax income
	CU	CU	CU
Continuing operations	40	20	60
Discontinued operations	–	20	20
Changes in pension liability recognised in OCI	–	–	–
Changes in available-for-sale securities recognised in OCI	–	–	–
Total	40	40	80

Example 21–Share-based payment transactions (paragraphs B41–B43)

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 B41, the difference between the tax basis of the employee services received to date (being the amount the tax authorities will permit as a deduction in future periods in respect of those services), and the carrying amount of nil, is a temporary difference that results in a deferred tax asset. Paragraph B42 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, on the basis of information available at the end of the period. If the amount that the tax 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 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 B43, 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 B43 requires that the excess of the associated current or deferred tax should be recognised directly in equity.

INCOME TAX

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
	CU		CU
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.^(a)

Year 1

Deferred tax asset and deferred tax income:

$$(CU50,000 \times 5 \times \frac{1}{3}^{(a)} \times 0.40) = \underline{\underline{CU33,333}}$$

(a) The tax basis 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 options' intrinsic value by one-third to arrive at the tax basis 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 CU83,333 ($CU50,000 \times 5 \times \frac{1}{3}$) is less than the cumulative remuneration expense of CU188,000.

	CU	CU
Year 2		
Deferred tax asset at year-end:		
(CU45,000 × 8 × $\frac{2}{3}$ × 0.40) =	96,000	
Less deferred tax asset at start of year	(33,333)	
Deferred tax income for year		<u>62,667^(b)</u>

(b) This amount consists of the following:

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

$$(CU45,000 \times 8 \times \frac{1}{3} \times 0.40) \quad 48,000$$

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

$$(a) \quad \text{increase in intrinsic value: } (CU45,000 \times 3 \times \frac{1}{3} \times 0.40) \quad 18,000$$

$$(b) \quad \text{decrease in number of options: } (CU5,000 \times 5 \times \frac{1}{3} \times 0.40) \quad (33,333)$$

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

INCOME TAX

The deferred tax income is all recognised in profit or loss, because the estimated future tax deduction of CU240,000 ($\text{CU}45,000 \times 8 \times \frac{2}{3}$) is less than the cumulative remuneration expense of CU373,000 (CU188,000 + CU185,000).

Year 3	CU
Deferred tax asset at year-end:	
(CU40,000 $\times$ 13 $\times$ 0.40) =	208,000
Less deferred tax asset at start of year	<u>(96,000)</u>
Deferred tax income for year	<u>112,000</u>

The deferred tax income is all recognised in profit or loss, because the estimated future tax deduction of CU520,000 (CU40,000 $\times$ 13) is less than the cumulative remuneration expense of CU563,000 (CU188,000 + CU185,000 + CU190,000).

Year 4	CU	CU
Deferred tax asset at year-end:		
(CU40,000 $\times$ 17 $\times$ 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 (CU40,000 $\times$ 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 (CU117,000 $\times$ 0.40) =	<u>46,800</u>	
Recognised in profit or loss		<u>17,200</u>

Year 5	CU	CU
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 (CU40,000 $\times$ 20 $\times$ 0.40) =	320,000	
Amount recognised in profit or loss (CU563,000 $\times$ 0.40) =	<u>225,200</u>	
Amount recognised directly in equity		<u>94,800</u>

INCOME TAX

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
	CU	CU	CU	CU	CU	CU
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

Disclosure of tax reconciliation

Paragraph 42 of the [draft] IFRS requires the disclosure of a tax reconciliation. The following example illustrates such a reconciliation.

Example 22

In 20X2 an entity has accounting profit in its own jurisdiction (country A) of CU1,500 (20X1: CU2,000) and in country B of CU1,500 (20X1: CU500). The tax rate is 30 per cent in country A and 20 per cent in country B. In country A, expenses of CU100 (20X1: CU200) are not deductible for tax purposes.

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