# SHORT COURSE

**The accounting for income taxes i.t.o.**

**IAS 12 *Income Taxes* (full IFRS) and**

**Section 29 *Income Taxes* (IFRS for SMEs)**

## - COURSE PACK -

**WELCOME TO THE COURSE!**

Thank you for choosing to attend/undertake this CPD learning activity.

This short course is designed to provide you with a detailed exposure to the concept of deferred taxation, as dealt with in **IAS 12 *Income Taxes*** (in full IFRS) and **Section 29 *Income Taxes*** (in the IFRS for SMEs). Section 29 of the IFRS for SMEs was fully aligned with IAS 12 in 2015, resulting in there being no difference in the approaches followed by these two documents.

<u>The course has been divided into two separate parts.</u>

**Part 1** of the course deals with the philosophy behind the calculation of and accounting for deferred (future) tax according to the **assets and liabilities approach**, incorporating the core principles relating to the **tax bases** of assets and liabilities.

**Part 2** of the course focuses on the six exceptions to the calculation of the tax bases of assets and liabilities. These exceptions arise when, although the principles relating to the tax bases of assets and liabilities having been applied correctly, these principles just do not lead to the correct outcomes in the calculation of deferred taxation. These exceptions almost always create exemption from deferred tax for certain typical temporary differences (i.e. as if they were *permanent* differences). Part 2 also refreshes the presentation (face of the AFS) and disclosure (notes to the AFS) requirements of these sections in IFRS and the IFRS for SMEs.

Both parts of the course contain videos, explanatory examples, and case studies, as well as milestone assessments of principles learnt to date, to facilitate in-depth learning.

At the end of the course, there is a summative assessment which will indicate the extent to which you have understood the principles contained in this short course.

I trust you will enjoy the content of the course and feel totally refreshed by the end of it!

Best regards

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# PART 1

**Milestone assessment 1: The assets and liabilities approach for deferred tax calculation**

Company ABC (Pty) Ltd provides you with the following correct information at their financial reporting date, being 30 September 2020:

| | 30/9/2020 | | 30/9/2019 | |
|---|---|---|---|---|
| | | | | |
| Buildings (at historic carrying amount) | R 12 850 000 | | R 14 500 000 | |
| Buildings (tax base) | R 10 000 000 | | R 12 000 000 | |
| | | | | |
| Land (at revalued carrying amount) | R 8 000 000 | | R 7 000 000 | |
| Land (tax base) | R 5 600 000 | * | R 5 400 000 | * |
| *(*assume the tax base to be correctly calculated)* | | | | |
| | | | | |
| Provisions (at historic carrying amount) | -R 1 500 000 | | -R 1 200 000 | |
| Provisions (tax base) | R - | | R - | |
| *(provisions are deductible for tax purposes* | | | | |
| *when paid in cash)* | | | | |

**Required**

(a) Calculate the deferred tax amount as it will appear in the statement of financial position (SoFP) of ABC (Pty) Ltd as at 30 September 2020 and 2019, using the *assets and liabilities approach* per IAS 12 *Income Taxes* / Section 29 *Income Taxes.* Determine whether deferred tax has increased or decreased from 2019 to 2020.

(b) Construct the journal entries (by asset and liability) that will be processed by ABC (Pty) Ltd as at 30 September 2020.

**Milestone assessment 1 – suggested solution**

**(a) Calculation of deferred tax balance at 30 September 2020 and 2019**

| | | | | | | |
|---|---|---|---|---|---|---|
| **30/9/2020** | | **CA** | **TB** | **TD** | **DTL/(A)** | |
| Buildings | | R 12 850 000 | R 10 000 000 | R 2 850 000 | R 798 000 | |
| Land | | R 8 000 000 | R 5 600 000 | R 2 400 000 | R 672 000 | |
| Provisions | | -R 1 500 000 | R - | -R 1 500 000 | -R 420 000 | |
| | | | | | **R 1 050 000** | |
| | | | | | | |
| **30/9/2019** | | **CA** | **TB** | **TD** | **DTL/(A)** | |
| Buildings | | R 14 500 000 | R 12 000 000 | R 2 500 000 | R 700 000 | |
| Land | | R 7 000 000 | R 5 400 000 | R 1 600 000 | R 448 000 | |
| Provisions | | -R 1 200 000 | R - | -R 1 200 000 | -R 336 000 | |
| | | | | | **R 812 000** | |
| | | | | | | |
| Deferred tax (SoFP) hence increased by R238 000 from 2019 to 2020. | | | | | | |

**(b) Journal entry as at 30 September 2020**

| **30/9/2020** | | **Debit** | **Credit** |
|---|---|---|---|
| Dr Income tax expense | P/L | R 98 000 | |
| Cr Deferred tax | SoFP | | R 98 000 |
| *(account for DT on buildings)* | | | |
| | | | |
| Dr Income tax expense | OCI | R 224 000 | |
| Cr Deferred tax | SoFP | | R 224 000 |
| *(account for DT on land)* | | | |
| | | | |
| Deferred tax | SoFP | R 84 000 | |
| Income tax expense | P/L | | R 84 000 |
| *(account for DT on provisions)* | | | |

**Milestone assessment 2: Calculating the tax base of an asset in terms of IAS 12 and Section 29**

DEF Limited approached you to assist with the calculation of certain of their deferred tax amounts. They have provided the following information to you, relating to their financial reporting date 31 December 2020.

The entity owns and occupies an administrative office building on which tax deductions are claimed in terms of Section 13 of the Income Tax Act. The office building is subsequently measured i.t.o. the revaluation model, with fair value adjustments recognised in other comprehensive income (OCI). Depreciation on the building is recognised in profit or loss over the useful life of the building, and the building has a residual value at which it is expected to be sold at the end of its useful life. The following information applies:

| | |
|---|---|
| **31-Dec-20** | |
| **Administrative building** | |
| Revalued carrying amount (RCA) | R 15 800 000 |
| Original cost price (OCP) and base cost (BC) | R 10 000 000 |
| Residual value | R 12 000 000 |
| Unclaimed tax allowances | R 9 000 000 |

The company does not intend disposing of the asset before the end of its useful life. The company is allowed to recognise, in full, any deferred tax asset that may arise in this calculation as at 31 December 2020.

**Required:**

(a) Calculate the future tax consequences of the building for DEF Limited, using the above information.

(b) Calculate the tax base of the building in terms of the assets and liabilities approach of IAS 12 and Section 29, so that your calculation proves your answer in part (a).

**Milestone assessment 2 – suggested solution**

**(a) Future tax consequences**

USE

Revenue arising through USE = depreciable part of the asset's carrying amount
= R15.8m (RCA) – R12m (RV, i.e. deemed selling price)
= R3.8m
Tax deductions available
= R9m
Hence, expected tax loss = (R5.2m)

| | |
|---|---|
| Future tax saving @28% | (R1 456 000) |

SALE

Recoupment
= SP limited to OCP, less UW&T
= R12m limited to R10m, less zero

| | |
|---|---|
| = R10m, taxed at 28% | R2 800 000 |

CGT
= Proceeds less base cost
= (Selling price less recoupment) less (CP less total W&T claimed)
= (R12m – R10m) less (R10m – R10m)

| | |
|---|---|
| = R2m, included at 80% and taxed at 28% | R448 000 |
| **TOTAL FUTURE TAX CONSEQUENCES** | **R1 792 000** |

**(b) Calculation of tax base of the asset**

What are the tax deductions still available to the entity as at 31 December 2020?

| | |
|---|---|
| ➢ The unclaimed tax deductions (W&T) on the building = | R9 000 000 |
| ➢ 20% of the expected capital gain, not included for CGT purposes (*) | |
| = R2m x 20% | R400 000 |
| | **R9 400 000** |

*Test:*
*CA = R15 800 000*
*TB = R9 400 000*
*TD = R6 400 000*
*DT = R1 792 000 (which matches the answer in part (a))*

*(*) Please note: This short course favours the calculation of the tax base of a revalued asset based on inclusion of the 20% portion that is NOT taxable in terms of capital gains tax. In South Africa, it is expected that capital gains tax (CGT) will be amended in the near future to include 100% of the capital gain in taxable income (instead of only 80%), in which case the issue around the 20% non-taxable portion of the capital gain will cease to exist. We believe that all temporary differences should be accumulated and multiplied by the company tax rate (currently 28%) and the calculation of deferred tax at various different rates (e.g. 28% vs 22,4%) should be avoided.*

| Milestone assessment 3: Calculating the tax base of a liability i.t.o. IAS 12 and Section 29 |
|---|

GHI (Pty) Ltd indicates the following liabilities in their statement of financial position (SoFP) as at 31 December 2020:

| | |
|---|---|
| Trade payables | (R2.4m) |
| Provisions | (R750k) |
| Deferred income | (R10m) |
| **Total current liabilities** | **(R13.15m)** |

The accountant has confirmed that trade payables are all deductible for tax purposes upon accrual, provisions are all deductible for tax purposes upon settlement in cash and all deferred income was taxed by the South Africa revenue authority upon receipt.

The company is able to recognise, in full, any deferred tax asset(s) that may arise in this calculation as at 31 December 2020.

**Required:**

Calculate the deferred tax, if any, on the current liabilities of GHI (Pty) Ltd as at 31 December 2020, using the assets and liabilities approach as per IAS 12 and Section 29.

**Milestone assessment 3 – suggested solution**

**Trade payables**

| | |
|---|---|
| ➢ CA | (R2.4m) |
| ➢ TB | (R2.4m) |
| ➢ TD | - |
| ➢ DTL/(A) (CA = TB) | - |

**Provisions**

| | |
|---|---|
| ➢ CA | (R750k) |
| ➢ TB | - |
| ➢ TD | (R750k) |
| ➢ DTL/(A) (CA > TB = DTA) | (R210k) |

**Deferred income**

| | |
|---|---|
| ➢ CA | (R10m) |
| ➢ TB | - |
| ➢ TD | (R10m) |
| ➢ DTL/(A) (CA > TB = DTA) | (R2.8m) |

**Total deferred tax relating to the current liabilities of GHI (Pty) Ltd** **(R3.01m)**

*(Note: this amount represents a deferred tax ASSET, i.e. future tax deductions are expected. This makes sense, as the entity will be able to deduct the deferred income (i.e. not get taxed on it again when it is earned by the company) and will also be able to deduct the provisions when their amounts are actually settled in cash. As these represent future tax deductions, the company recognises a deferred tax ASSET on the temporary differences).*

# PART 2

**Milestone assessment 4:**
**Understanding the exceptions to the calculation of tax bases for assets and liabilities**

**<u>Scenario 4.1</u>**

Entity ABC (Pty) Ltd incurred development costs of R5 million on 1 July 2020 and correctly capitalised the development cost as an intangible asset in their statement of financial position as at 31 December 2020. The company amortises the development cost on the straight-line basis over its useful life of five years. There is no residual value. The South African Revenue Service (SARS) grants capital allowances on only 80% of the costs incurred, being R4 million, at 25% per annum with no time apportionment. None of the transactions were incurred in terms of a business combination transaction.

**Required:** Calculate the amount of deferred tax that is attributable to the intangible asset as at 31 December 2020 in terms of the requirements of IAS 12 *Income Taxes* / Section 29 *Income Taxes (IFRS for SMEs).* Use the assets and liabilities approach.

**<u>Scenario 4.2</u>**

DEF Limited provides you with the following information at their respective reporting dates (being 31 December):

| | **2019** | **2020** |
|---|---|---|
| Profit before taxation (per profit/loss) | R10 000 000 | R13 000 000 |
| Permanent differences (exempt income) | (R500 000) | (R800 000) |
| Temporary differences (net) | (R12 000 000) | (R14 000 000) |

The financial manager of the company indicates at 31 December 2019 that only 25% of the assessed loss holds substantive future economic benefit for the entity. On 31 December 2020, the financial manager indicates that 75% of any assessed loss holds substantive future economic benefit for the entity. The information that led to the change from 25% to 75% only became available in the 2020 financial reporting period.

**Required:** Provide the journal entries that should be processed by DEF Limited as at 31 December 2019 <u>and</u> 31 December 2020, in terms of the requirements of IAS 12 *Income Taxes* and Section 29 *Income Taxes (IFRS for SMEs).*

**Milestone assessment 4 – suggested solution**

**Scenario 4.1**

| | CA | TB | TD | DTL/(A) |
|---|---|---|---|---|
| Intangible asset (R5m/5 years x 6/12) | | | | |
| ➢ Initial recognition exempted | | | | |
| (R1m x 54/60) | R900 000 | R900 000 | 0 | 0 |
| ➢ Non-exempted portion | | | | |
| (R4m x 54/60) / (R4m x ¾) | R3 600 000 | R3 000 000 | R600 000 | R168 000 |

*Explanation*

In terms of the tax treatment, SARS allows only deductions on R4m of the R5m costs incurred, hence the R1m is a permanent difference, and already exists at initial recognition. The initial recognition exemption from deferred tax is applicable to the R1m difference, and will always be equal (even subsequently) to the carrying amount of that portion of the asset (i.e. R900 000 tax base is stated equal to the calculated R900 000 carrying amount at reporting date).

The remainder of the asset's carrying amount (i.e. R4m of R5m) is treated as usual, with tax deductions occurring faster than accounting deductions, hence creating an expectation of tax in the future when the tax deductions "dry up". We therefore recognise a deferred (future) tax liability of **R168 000**, as the carrying amount of the asset of R3.6m (i.e. minimum expected future economic benefits) exceed the remaining tax deductions (i.e. R3m) by R600 000, which leads to temporary differences that are expected to reverse over the next 4½ years.

**Scenario 4.2**

| | 2019 | 2020 |
|---|---|---|
| Profit before tax (accounting) | R10 000 000 | R13 000 000 |
| PDs | (R500 000) | (R800 000) |
| TDs (taxable) | (R12 000 000) | (R14 000 000) |
| Assessed loss b/fwd | - | (R2 500 000) |
| **Assessed loss** | **(R2 500 000)** | **(R4 300 000)** |
| | | |
| Potential DTA (if recognised in full) at 28% | R700 000 | R1 204 000 |
| DTA to be recognised (R700 000 at 25%) / (R1 204 000 x 75%) | R175 000 | R903 000 |

**Journal entries – 2019**

| | Dr | Cr |
|---|---|---|
| Dr Income tax expense (P/L) (R12m x 28%) | R3 360 000 | |
| Cr Deferred tax (SoFP) | | R3 360 000 |
| *(recognise DT on taxable TDs)* | | |
| | | |
| Dr Deferred tax (SoFP) | R175 000 | |
| Cr Income tax expense (P/L) | | R175 000 |
| *(recognise 25% DTA on assessed loss)* | | |

**(PTO)**

**Journal entries – 2020**

| | | |
|---|---|---|
| Dr Income tax expense (P/L) (R14m x 28%) | R3 920 000 | |
| Cr Deferred tax (SoFP) | | R3 920 000 |
| *(recognise DT on taxable TDs)* | | |
| | | |
| Dr Deferred tax (SoFP) ([R700 000 x 75%] – R175 000) | R350 000 | |
| Cr Income tax expense (P/L) | | R350 000 |
| *(catch up on DTA of 2019 that can now be recognised)* | | |
| | | |
| Dr Deferred tax (SoFP) [(R1 204 000 – R700 000) x 75%] | R378 000 | |
| Cr Income tax expense (P/L) | | R378 000 |
| *(recognise DTA on addition to assessed loss in 2020)* | | |

*<u>Proofs:</u>*

| | | |
|---|---|---|
| *DTL recognised in 2019* | *R3 360 000* | |
| *DTA recognised in 2019* | *(R175 000)* | |
| | | |
| *DTL recognised in 2020* | *R3 920 000* | |
| *DTA recognised in 2020 (R350k + R378k)* | *(R728 000)* | |
| | | |
| *Cumulative DTA (2019)* | *R175 000* | |
| *Proof: R2,5m assessed loss x 28% x 25% limit* | *R175 000* | *correct* |
| | | |
| *Cumulative DTA (2020) (R175k + R728k)* | *R903 000* | |
| *Proof: R4,3m assessed loss x 28% x 75% limit* | *R903 000* | *correct* |

**Milestone assessment 5: Performing a tax rate reconciliation for purposes of disclosure**

Use the information from milestone assessment 4.

**Required:** Perform a tax rate reconciliation for inclusion in the tax expense note disclosure in the notes to the annual financial statements of DEF Limited for the 2019 and 2020 financial reporting periods. The reconciliation is to be done in numerical format.

**Milestone assessment 5 – suggested solution**

| | 2019 | 2020 |
|---|---|---|
| Profit before taxation | R10 000 000 | R13 000 000 |
| Tax expense (per J/Es) (R3 360k – R175k) | R3 185 000 | |
| Tax expense (per J/Es) (R3 920k – R350k – R378k) | | R3 192 000 |
| | | |
| Tax rate reconciliation | | |
| Tax at statutory rate on profit before tax | R2 800 000 | R3 640 000 |
| Exempt income (R500k x 28%) / (R800k x 28%) | (R140 000) | (R224 000) |
| Deferred tax on assessed loss NOT created (2019) (R700k – R175k) | R525 000 | |
| Deferred tax on assessed loss created i.r.o. 2019 [(R700k x 75%) – R175 000] | | (R350 000) |
| Deferred tax on assessed loss NOT created (2020) (R1 204k – R700k) x 25%) | | R126 000 |
| Total tax expense (per P/L) | R3 185 000 | R3 192 000 |
| | | |
| Effective tax rate | 31,85% | 24,55% |
| *Statutory tax rate* | *28%* | *28%* |