

Application of Deferred Taxation as per LKAS 12 Income Taxes (Effective from 1st January 2012) to entities enjoying a Tax Holiday period

Issue

LKAS 12 – Income Taxes (Effective from 1st January 2012) states that deferred tax should be recognised for all taxable temporary differences subject to a few specific exemptions. However, LKAS 12 (Effective from 1st January 2012) does not make specific references to the treatment to be adopted for entities which are enjoying tax exemption periods (tax holidays).

Clarification is sought on the following:

1. Should an entity enjoying a tax holiday recognise deferred tax in their financial statements, for temporary differences which will reverse after the expiry of the tax holiday period?
2. Whether property, plant and equipment purchased during the tax holiday period, which would if not for the tax holiday have qualified for capital allowances, have a tax base for the purpose of this Standard?

Sri Lanka Accounting Standard

LKAS 12 – Income Taxes (Effective from 1st January 2012)

Scope

This ruling shall be applicable for the entities who apply the full SLFRSs/ LKASs and does not apply to those entities who apply the Sri Lanka Accounting Standard for Small and Medium Sized Entities.

Discussion/Analysis

As per the Objectives of LKAS 12 – Income Taxes (Effective from 1st January 2012), “*the principal issue in accounting for income taxes is how to account for the current and future tax consequences of:*

- a) the future recovery (settlement) of the carrying amount of assets (liabilities) that are recognised in an entity’s balance sheet; and*
- b) transactions and other events of the current period that are recognised in an entity’s financial statements.*

It is inherent in the recognition of an asset or liability that the reporting entity expects to recover or settle the carrying amount of that asset or liability. If it is probable that recovery or settlement of that carrying amount will make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences, this Standard requires an entity to recognise a deferred tax liability (deferred tax asset) with certain limited exceptions”.

Thus for an entity which enjoys tax holidays, would have future tax consequences due to future recovery (settlement) of the carrying amount of assets (liabilities) after the expiration of the tax holiday period.

LKAS 12 (Effective from 1st January 2012) paragraph 5 defines deferred tax liabilities as “*the amounts of income taxes payable in future periods in respect of taxable temporary differences*” and deferred tax assets as “*the amounts of income taxes recoverable in future periods in respect of: (a) deductible temporary differences; (b) the carry-forward of unused tax losses; and (c) the carry-forward of unused tax credits*”. The tax base of an asset or liability is “*the amount attributed to that asset or liability for tax purposes*”. In other words, a tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset. If those economic benefits will not be taxable, the tax base of the asset is equal to its carrying amount. The Standard defines Temporary Differences as:

“differences between the carrying amount of an asset or liability in the balance sheet and its tax base. Temporary differences may be either:

- (a) taxable temporary differences, which are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled; or*
- (b) deductible temporary differences, which are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.”*

Further paragraph 15 of LKAS 12 (Effective from 1st January 2012) states that:

“A deferred tax liability shall be recognised for all taxable temporary differences, except to the extent that the deferred tax liability arises from:

- (a) the initial recognition of goodwill; or*
- (b) the initial recognition of an asset or liability in a transaction which;*
 - (i) is not a business combination; and*
 - (ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).*

However, for taxable temporary differences associated with investments in subsidiaries, branches and associates, and interest in joint ventures, deferred tax liability shall be recognised in accordance with paragraph 39.”

Similarly paragraph 24 states:

“A deferred tax asset shall be recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised, unless the deferred tax asset arises from initial recognition of an asset or liability in a transaction that:

- (a) is not a business combination; and*
- (b) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).*

However, for deductible temporary differences associated with investment in subsidiaries, branches and associates, and interests in joint arrangements, a deferred tax asset shall be recognised in accordance with paragraph 44.”

Measurement of deferred tax is discussed from paragraph 46 to 56 and in paragraph 46 and 47 it states:

“46 – Current tax liabilities (assets) for the current and prior period shall be measured at the amount expected to be paid to (recovered from) the taxation authorities, using the tax rates (and the tax laws) that have been enacted or substantively enacted by the end of the reporting period.

47 – Deferred tax assets and liabilities shall be measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.”

Thus, tax implications arising from property, plant and equipment after the expiration of the tax holiday, is to be considered as deferred tax assets or liabilities as stated above.

Further, for property, plant and equipment (or other asset/liability) for which tax effects do not extend beyond the tax exemption period, economic benefits will not be taxable, and the tax base of an asset or liability would equal its carrying amount. However, when there is taxable economic benefits that will flow to the entity after the tax exemption period, recovering the carrying amounts of the assets/liabilities, there will be a tax base different to the carrying amount in respect of those assets/liabilities. I.e. there will be temporary difference that is scheduled to be reversed subsequent to the tax exemption period. To that extent a temporary difference shall arise and LKAS 12 (Effective from 1st January 2012) will be applicable.

Therefore, deferred tax on temporary differences reversing within the tax exemption period is measured at that tax rate that is expected to apply during the tax exemption period, which the lower or nil tax rate. Deferred tax on temporary differences reversing after the tax exemption period is measured at the enacted or substantially enacted rates that are expected to apply after the tax exemption period.

However, if an entity has definitive plans of disposing its assets or liabilities during the tax exemption period, there will be no necessity for considering deferred tax assets/liabilities as it can be considered that tax effects do not extend beyond the tax exemption period in respect of the Company. Financial implications arising based on such plans shall be considered in preparation of such financial statements. Further, financial statements shall contain full disclosure of such plans.

Opinion

Based on the Discussion and Analysis above, our Rulings on the issue are:

- 1. Deferred Tax shall not be considered nor provided for assets/liabilities for which tax impacts and reversals take place within the tax exemption period. There will be no tax implications that take place after the expiration of the tax exemption period for such assets.**

2. **An entity enjoying a tax exemption period shall recognise deferred tax in their financial statements for temporary differences, where reversals of such differences extend beyond the tax exemption period.**
 - a) **Where an Entity is entitled to claim the total value or any part of expenditure made during the tax holiday period, as deductions for tax purposes after the tax holiday period, such an entity will treat such amount of expenditure as part of the tax base throughout the tax holiday period for the purpose of recognising deferred tax.**
 - b) **Where an Entity is not entitled to claim the total value or any part of expenditure made during the tax holiday period, as deductions for tax purposes after the tax holiday period, such an entity will take into consideration such amount of expenditure in determining the tax base in each accounting period throughout the tax holiday period for the purpose of recognising deferred tax.**
3. **The tax rate would be the enacted or substantially enacted tax rates that are expected to apply after the tax exemption period.**
4. **Property, plant and equipment purchased during the tax holiday period would have a tax base for the purpose of the Standard provided that taxable economic benefits will flow to the entity after the tax exemption period.**

Note: - Where an entity adopts the principles recommended in this ruling for the first time, the effects of such application should be recognized in the financial statements in compliance with LKAS 8.