Frequently Asked Questions (FAQs) on the Calculation of Deferred Tax implications from the Enactment of New Inland Revenue Act

Background:

Inland Revenue Act, No. 24 OF 2017 comes into operation on April 1, 2018 and the transitional provisions have been issued recently. Therefore, in terms of the paragraph 47 of LKAS 12, 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. Further, in the paragraph 28 of LKAS 34 Interim Financial Reporting, the same accounting policies shall be applied in its interim financial statements as applied in the annual financial statements.

Accordingly, the tax rates and laws provided in the Act shall be used in computing deferred tax with immediate effect.

Issue 01: What is the impact on deferred tax from the introduction of tax on realization of capital & investment assets?

As per Section 6 (2) of the *Inland Revenue Act, No. 24 of 2017*, in calculating a person's gains and profits from conducting a business for a year, gains from the realisation of capital assets and liabilities of the business shall also need to be considered (will be taxed under First schedule at 28%). Further, as per Section 7(2) (b) of the said Act, the gains from the realisation of investment assets are treated as part of the investment income and shall be taxed to the company at the rate of 10%.

Further, in terms of Section 6 (2)(g), in calculating a person's gains and profits from conducting a business for a year of assessment, amounts derived that are effectively connected with the business and that would otherwise be included in calculating the person's income from an investment are need to be considered.

In arriving at gains from the realization of investment assets in terms of Section 203 (4), the cost of an investment asset held by a person as at, September 30, 2017 is equal to the market value of the asset at that time.

Section 195 includes the following interpretations:

"investment" means –

(*a*) the owning of one or more assets, including one or more assets of a similar nature or that are used in an *integrated fashion*, and
- (i) includes a past, present or prospective investment; but
- (ii) excludes a business or employment; or

(*b*) a game of chance, including lotteries, betting or gambling;

"investment asset"

(a) means a capital asset held as part of an investment, but-

(b) excludes the principal place of residence of an individual, provided it has been owned by the individual continuously for the three years before disposal and lived in for at least two of those three years (calculated on a daily basis);

"capital asset"
(*a*) means each of the following assets: -
(i) land or buildings;
(ii) a membership interest in a company, partnership or trust;
(iii) a security or other financial asset;
(iv) an option, right or other interest in an asset referred to in the foregoing paragraphs; but
(*b*) excludes trading stock or a depreciable asset;

Accordingly, on the revaluation surplus of resulting capital and investment assets, deferred tax liabilities will arise and measured at the applicable tax rates (normal tax rates or at the rate of 10% respectively) considering the deemed cost (original cost or fair value as at 30 September 2017 respectively) for tax purposes. The assessment on whether an asset is an investment asset or a capital asset has to be determined by applying the judgement of the management upon referring the provisions of the Inland Revenue Act.

Issue 02: Will the carried forward tax credits be claimable under the New Inland Revenue Act?

In terms of paragraph 34 of LKAS 12, a deferred tax asset shall be recognised for the carryforward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised.

Reversal of the deferred tax assets and liabilities that has been recognised due to the carried forward tax credits and tax losses from the previous year of assessment, need to be done subject to the assessment on the availability of future tax profits to set off such unused tax credits and losses in terms of LKAS 12 and the restrictions on the claimability under the new Tax law.

Issue 03: What would be the accounting treatment for the deferred tax assets and liabilities arising from the changes in the Income Tax Act?

In terms of paragraph 60 of LKAS 12, the carrying amount of deferred tax assets and liabilities may change from a change in tax rates or tax laws, and the resulting deferred tax is recognised in profit or loss, except to the extent that it relates to items previously recognised outside profit or loss (further reference in paragraph 63).

As per paragraph 61A of LKAS 12, current tax and deferred tax shall be recognised outside profit or loss if the tax relates to items that are recognised, in the same or a different period, outside profit or loss. Therefore, current tax and deferred tax that relates to items that are recognised, in the same or a different period:

(a) in other comprehensive income, shall be recognised in other comprehensive income (further ref: in para 62).

(b) directly in equity, shall be recognised directly in equity (further ref: in para 62A).

For this purpose, in terms of paragraph 7 of LKAS 1 and paragraph 62 of LKAS 12, a change in carrying amount arising from the revaluation of property, plant and equipment (see LKAS 16) will form a part of the components of other comprehensive income.